# CHAPTER 5

# PROMOTING SDGS AND SHARED PROSPERITY: THE POTENTIAL ROLE OF ISLAMIC ECONOMICS AND FINANCE

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**Abstract**

Islamic Economics and Finance (IEF) system can play an important role in promoting SDGs because IEF system is inherently positioned to address some of the main global challenges that are also highlighted by SDGs: high rates of poverty and inequality, frequent and severe banking and financial crises, and economic growth that is environmentally unsustainable and excludes the poor. A detailed theoretical discussion regarding the potential role of IEF in promoting SDGs is presented in the first part of this chapter. Given that financial inclusion is an important factor in achieving SDGs, the second part of this chapter employs World Bank's 2017 round of Findex data alongside cross-country regression analysis to examine the role of Islamic finance in enhancing financial inclusion among Muslim communities. The findings of this chapter identify some of the most important links between and an IEF system and SDGs. Furthermore, it establishes the fact that increasing access to Islamic financial services can increase financial inclusion in Muslim majority countries which in turn can help reduce poverty, inequality, instability, and economic exclusion in these countries. The logical outcome and policy implication of the theoretical arguments and empirical findings highlighted above is that enhancing access to Islamic financial services can play an important role in promoting SDGs.

**Keywords:** SDGs, Islamic economics, Islamic finance, financial inclusion, sustainability

## 1. SDGs, Shared Prosperity, and Global Economic and Financial Challenges: An Islamic Perspective

Many financial and economic problems threaten the long-term wellbeing of global economy and hinder the realization of SDGs. One can point to increasing levels of economic & financial volatilities, rising poverty and inequality, and environmentally unsustainable economic paradigm as some of the main challenges facing the global community. The interconnected nature of these challenges calls for a holistic paradigm that could address them in simultaneous manner through one comprehensive approach.

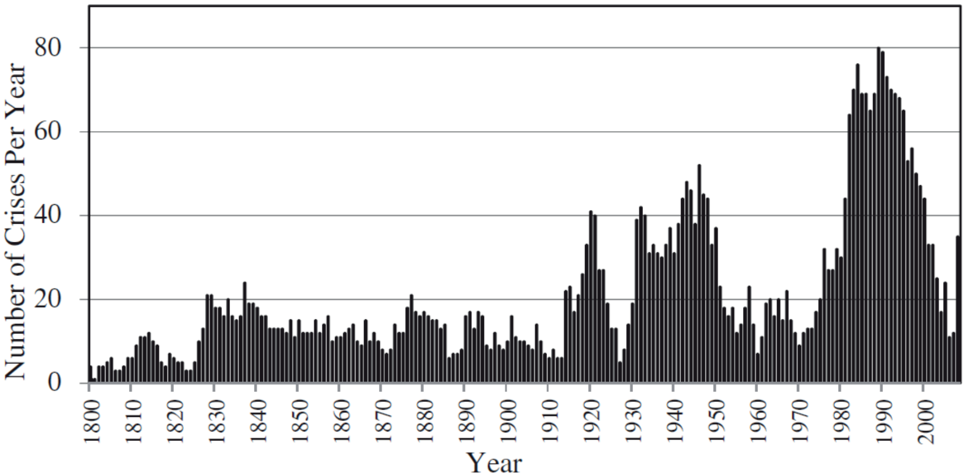
### 1.1. Economic and Financial Instabilities and Volatilities

The available data suggest that the global economy and financial industry has become more and more unstable and volatile over the past century. "Over the past three decades, financial crises have become a more frequent phenomenon. According to data compiled by Reinhart and Rogoff (2008) [a summary of which is presented in Figure 1] a total of 1,611 financial crises occurred during 1905–75, where financial crises are defined as periods of significant distress in currency markets, the banking sector, domestic debt, external debt, and/or inflation. In contrast, for the period 1976–2008 alone, this count stands at 1,618" (Mohseni-Cheraghlou 2016, 88). In other words, financial crises have become 2.3 times more frequent in the period 1976-2008 when compared to the highly tumultuous period of 1905-1975. While World Wars I and II were the main reasons for the higher incidence of financial crises in the periods 1915-1925 and then throughout 1940s, conflicts at such scales have been absent in the past four decades.

Many reasons have been cited for the increasing economic and financial volatilities. The removal of the global monetary system off the gold standard, increasing interconnectedness of the global banking and financial centers and hence the increasing likelihood of contagion, back-to-back oil shocks of the1970s, and the Reagan and Thatcher deregulation of the 1980s in the U.S. and the U.K. are some of the often mentioned factors. Mohseni-Cheraghlou (2016) provides ample empirical evidence spanning three decades ending in the great recession of 2007-2009 that shows low- and middle-income countries are often hit the hardest during episodes of financial crises, increasing multidimensional poverty and inequality at the global level.

## 1.2. High Levels of Poverty and Inequality

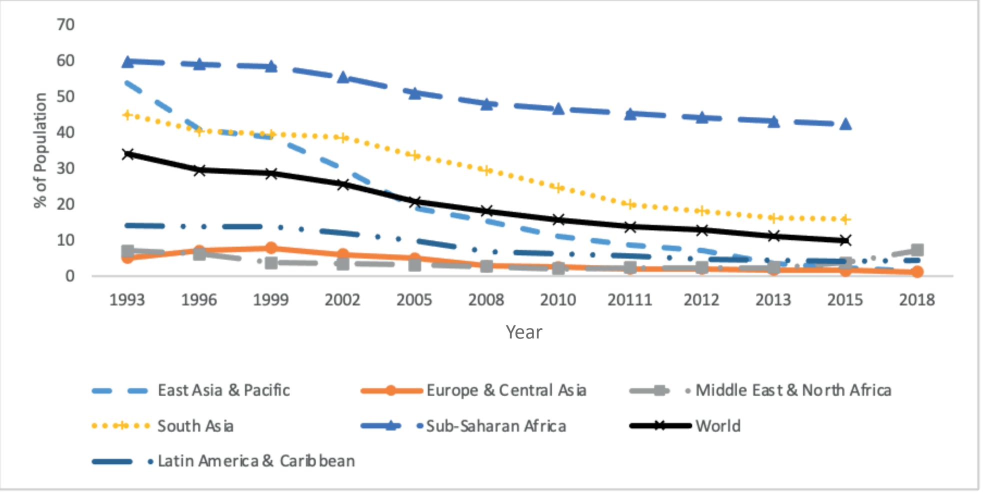
According to the World Bank estimates around 800 million people around the world are under the extreme poverty line of $1.90 PPP a day. While poverty figure is substantially down from about 1,900 million people in 1990, most of this progress is due to the successes of East Asia and Pacific (Figure 2) in countries such as China and more recently Malaysia, Indonesia, Thailand, and Vietnam. Between 1981 and 2015, China alone has been able to reduce extreme poverty headcount by about 600 million people or almost, a whopping decline of 95%.




Source: Mohseni-Cheraghlou (2016, 89).

**Figure 1.** Frequency of Financial Crises in the World (1800-2008)

In other words, more than half of the reduction in world's extreme poverty headcount is due to China. However, the picture is not as rosy in other parts of the world. Hosting more than half of world's extremely poor (or about 400 million people), more than four out of ten residents of Sub-Saharan Africa still live in extreme poverty. Such high levels of poverty are also exacerbated by the fact that about 620 and 700 million residents of Africa (or more than half of the population of this resourceful continent) do not have access to electricity and basic sanitation, respectively. Furthermore, 320 million people in Africa (or a quarter of Africans) live without access to clean and reliable drinking water sources. Hence, in addition to income poverty, Africa is suffering from severe forms of multidimensional poverty (Alkire et al. 2017) such as poverty in access to water, electricity, and sanitation which by extension will contribute to poverties in education, health, and security.




Source: World Development Indicator (2019). Author's Calculation.

**Figure 2.** Poverty headcount ratio at $1.90 a day (2011 PPP) (% of population), 1993-2018

As a related issue to multidimensional poverty, increasing levels of within and between country multidimensional inequalities is also at the forefront of global issues. As we saw earlier, while poverty headcount is experiencing rapid declines in some countries and parts of the world, other countries and regions are seeing little progress and even reversals in poverty headcounts. Clearly, such trends are an indication of increasing levels of inequalities between different countries and regions. Nonetheless, since 1990, global inequality —the inequality among all citizens worldwide, regardless of their country of residence— has decreased. Like the reduction of global extreme poverty headcount, the recent decline in global inequality is mainly driven by rapid growth rates in developing countries with large populations, namely China and India. Even though global inequality has been on the decline in the past 25 years, the share of income of the top one percent has increased and within country inequalities are higher today than they were 25 years ago, especially in poorer and developing economies. "Inequality remains unacceptably high in many countries around the world. Developing countries tend to exhibit higher levels of inequality than developed countries. Latin America and the Caribbean, along with Sub-Saharan Africa, stand out as historically high-inequality regions" (World Bank 2016, 88).

### 1.3. Environmental Degradation, Depletion of Natural Resources, and Pro-Rich Growth Bias

According to the data and reports by the World Bank, World Health Organization (WHO), and other international organizations, the global economy is on an environmentally unsustainable path and runs the long-run risk of total collapse if meaningful steps are not taken to reverse the current course. Below are a few disturbing facts about the state of the environment:

- Air pollution is the fourth leading cause of premature deaths imposing a hefty annual welfare loss of around $5 trillion on global economy and it is the cause of 1 in 10 of all deaths worldwide.(World Bank& IHME,2016)
- About one-tenth of the world's population or around 700 million people don't have access to clean drinking water. (Caballero, 2015)
- About 70% of the world's ecosystems are facing threats of vanishing as they are degrading faster than they can recover.(World Bank, 2020) Moreover, more than 3,200 species of mammals, 6,900 of fish, 3,600 of birds, and 13,600 species of higher plants currently threatened with extinction. (Caballero, 2015) The environmental impacts of such extinction are currently not fully understood.
- At current levels of consumption patterns and keeping the projected economic growth and new oil discoveries in mind, the world has enough oil to last for 25 years.
- The depletion of global water resources is more severe that the current oil depletion. This is because while there are substitutes for oil as a source of energy, there is no substitute for drinking water, the single most ingredient of life in the blue planet.
- Half of the world's forest has been cleared, contributing to about 15% of global greenhouse gas emissions every year. Additionally, about 7.2 million hectares of forests are destroyed each year.
- Each year more than 1.2 billion tons of waste is dumped into the earth and it is to be tripled by 2100. (World Bank, 2013)

While the above are threatening the overall wellbeing of the global community, the vulnerable and the poor are impacted the most. For example, air pollution is mainly affecting the poorer people and countries as 86% of the residents in low- and middle-income countries are exposed to air pollution levels (measured in term of PM 2.5) that are larger than the WHO guidelines. Also, while one-third of the population in low-income countries suffer from a lack of access to clean drinking water, only less than one percent of the population in high-income countries do.(Caballero, 2015) Moreover, solid and liquid wastes are often dumped in areas far away from the urban centers, therefore disproportionately impacting the population in slumps and rural areas. Furthermore, richest countries consume 10 times as much as natural resources as the poorest countries do.[1] Finally, 78% of the world's extremely poor live in rural areas and their livelihoods directly depend on forests, lakes, rivers and oceans, all of which are degrading continuously because of the unsustainable economic activities and conspicuous consumption patterns of mainly the non-poor. (Olinto et al.,2013)

### 1.4. SDGs and Enhancing Shared Prosperity: A Holistic Islamic Perspective

Accomplishing SDGs and enhancing shared prosperity will require a holistic approach that is capable of addressing the challenges outlined above. For example, long-run equitable and inclusive growth will not be truly possible without paying attention to multidimensional poverty and inequality. Stability cannot be materialized if long-run sustainable and inclusive growth is not in place, while poverty and inequality will not be effectively addressed without economic and financial stability. Any framework or approach that heeds to one or some of these dimension(s) more than other(s) will fail to enhance shared prosperity. For example, an economic and financial system primarily concerned about economic growth will take poverty, inequality, and sustainability into consideration only in the face of political and social pressure or when growth is threatened. Clearly, this has been the case for the capitalist economic framework where poverty, inequality, and environmental issues were only heeded to after they posed serious threats to the survival and existence of the system itself in the long run. In other words, SDGs and shared prosperity and their various elements are NOT inherent to a capitalist economic order and are therefore ignored until they start undermining the system's existence and functionality. Clearly, such a framework inherently lacks the ability to enhance SDGs and shared prosperity because these are not integral to its set of objectives and are only temporary add-on features. Once the capitalism system figures out how to continue its operation and ensure its survival without heeding to SDGs and shared prosperity, these concepts will get ignored, just like they were for much of the 20th century.

Unlike capitalism, the dominant economic paradigm of our time, an IEF framework considers SDGs and shared prosperity, as necessary, inherent, and inseparable components of its existence. In other words, the abundance of Quranic verses, prophetic narrations (*Hadith*),

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1 See https://www.ecowatch.com/humans-consumption-of-earths-natural-resources-tripled-in-40-years- 1943126747.html. For example, "Europe and North America, which had annual per capita material footprints of 20 and 25 tons in 2010, are at the top of the table. China's footprint was 14 tons and Brazil's 13. The annual per-capita material footprint for Asia-Pacific, Latin America and the Caribbean and West Asia was 9-10 tons, and Africa's was below 3 tons" (Kirby 2016, 1).

and cases from the Islamic history[2] make it clear that an economic and financial system can only be referred to as genuinely Islamic when SDGs and shared prosperity are heeded to and actively pursued while also none of the goals is sacrificed for the sake of others. In this framework, there is no "tradeoff" between economic justice and environmental sustainability versus economic efficiency and growth because these concepts are not defined separately from each other and are in fact strongly intertwined and dependent on each other. As a result, an IEF framework is equipped with the necessary philosophical and practical apparatus to have the potential of offering a holistic framework within which these global challenges could be identified and effectively addressed.

### 1.5. IEF and Economic and Financial Stability

Global financial crises of 2007-2009 reinforced the importance of the stability in the financial industry for academicians and the policymaking community. As a result, a new strand of articles, books, and reports started analyzing various issues related to the stability of a financial system. Among these were a new line of research focusing on the stability of an IEF system. The common finding of this line of research, both theoretical and empirical, has been that Islamic financial institutions are inherently more stable when compared to their conventional counterparts. This is mainly because, by the decree of Islamic legal system, speculation and excessive risk taking is prohibited in an IEF system. Moreover, financial activities in this system must be linked to the real sector of the economy. In other words, in an IEF system, debt-based financing that is not backed by real assets is non-existing and is replaced with equity-based or asset-backed financing. In case of equity-based financing (such as *Mudaraba* and *Musharaka* contracts) the financiers (i.e. the banks) are in fact partners and investors in the projects and endeavors for which they are providing finances. In the case of asset-backed debt financing (such as *Murabaha* contract) the bank is the owner of the asset which is being sold in installments to the client (i.e. the borrower). In both cases, Islamic financial institutions are sharing the risk with their clients and are not simply providing finances and collecting a fixed rate on them.

Clearly, the prohibition of speculation, excessive risk taking, and debt-based financing lead to financing and investments that are less risky. Such investments are also more strongly linked to the real economy and is therefore associated with real economic output, which in turn, promote more stability in the economic and financial system. The 2007-2009 global financial crises and the likes before it in various countries are apparent showcases of the

2 In another paper, I have complied the many verses, *Ahadith*, and historical narratives providing strong evidence that SDGs in general and shared prosperity in particular are inherent to an IEF system.

kinds of instabilities a financial system would be exposed to when speculation, excessive risk taking, and debt-based financing are at the core of the operation of financial institutions and their incentive structures. Such risks and instabilities tend to grow with the size of these institutions as they become "too large to fail" and moral hazard kicks in. At that point, the managers of such institutions have all the incentives to take more risk as they have a sense, that extreme losses will most likely be covered by the government and tax-payers' money in forms of bail-outs. This will increase the risk and the instability in a financial system, imposing immense costs on the larger economy and society. By prohibiting speculation, excessive risk taking, and debt-based financing that is not backed by real assets, an IEF system would avoid such risky and immoral behaviors and their eventual harmful outcomes for the economy.

The current banking system is not able to accommodate an IEF system. From the banking perspective, an IEF system would require a two-tier banking model. First tier would be banks that only take deposits and make payments. Such banks "would accept deposits for safekeeping without accruing any return and must maintain one hundred percent reserves. This protects the payment system of the economy, while concurrently limiting the credit-creating ability of the banking system" (Askari et. al. 2012, 5). The 100% reserve banking mentioned here was also suggested by Irving Fisher in the "Chicago Plan" after the Great Depression which was also endorsed by Milton Friedman. It limits the power of creating money to the central bank, therefore limiting credit bubbles and the subsequent busts which contribute to the stability of a financial system.[3]

The second tier in such a model would be an investment component which "would function as a financial intermediary, channeling savings into investment projects. Deposits in these investment banks would be considered equity investments with no guarantees for their face value at maturity, and are subject to profit-and-loss sharing. Depositors would be investors in the pool of assets maintained by the investment bank on the asset side of its balance sheet" (Ibid, 5). Such a profit-and-loss sharing (PLS) framework will also contribute to the stability of a financial system as depositors will be more prudent and selective about the banks in which they will be depositing their funds as investors. Moreover, this will in turn encourage banks to only get involved in projects that are less risky and more profitable. As a result, riskier and questionable projects will have a lower likelihood to attract financing from an investment bank operating based on *Shari'ah* guidelines.

3 Another suggestion in similar line was put forth more recently by King (2016). He suggested the idea of "narrow banking", where all deposits are backed by safe and liquid assets.

There are several widely known contractual frameworks through which the above-mentioned equity-based financing can take place in an IEF system a summary of which is provided in Table 1 below. It is important to note that while all these contractual frameworks are appropriate for addressing the financing needs of SMEs as well as large enterprises, for various reasons, *Murabaha* is currently the most commonly used form of financing in today's IEF system.

**Table 1.** Equity-based Islamic financing

| Financing Scheme | Brief Description | Most Appropriate Target Population |
|---|---|---|
| Mudaraba | The supplier of capital (the lender) contracts with a working partner (the borrower) based on sharing the resulting profits. Losses, if any, are considered loss of capital and borne by the owner of capital. The working partner, in that case, goes unrewarded for its efforts. This is the 'loss' borne by the working partner, a feature of Mudaraba which has led some to characterize it as 'profit and loss sharing' (PLS). The Mudaraba contract when applied to farming is called Muzara'ah or sharecropping. | Poor or non-poor who lack capital but have skills to carry out or manage a specific business operation. |
| Musharaka | Two or more parties supply capital as well as work/effort. They share the resulting profits according to agreed proportions, but losses are to be borne in proportion to the respective capitals. | Non-poor. |
| Murabaha | A sale agreement under which a seller purchases goods desired by a buyer and sells it to him/her at an agreed marked up price, but with a deferral of payment as agreed in the contract. | Poor or non-poor who can pay for an item they need (either for small business or household use) in installments. |
| Muzara'ah | Mudaraba applied to agriculture sector. An agreement between two parties in which one agrees to allow a portion of his land to be used by the other in return for a part of the produce of the land. | Poor or non-poor who lack capital but have skills to carry out agricultural operations. |
| Salam | Payment is made now for agricultural products to be delivered at a specified time in future with the price being agreed now. | Poor or Non-poor |
| Istisna | Salam applied to manufactured goods, with the possibility of payment in installments as the goods are delivered. | Poor or Non-poor |
| Ijara | The leasing of a property, capital good, or any other good. | Poor or Non-poor |
| Sukuk | Bonds that are in compliance with Shari'ah, which are based on partial ownership of asset, investment, or business. The issuer of a Sukuk sells an investor the certificate, who then rents it back to the issuer for a predetermined rental fee. The issuer also makes a contractual promise to buy back the bonds at a future date at face value. Issuer could be private or sovereign entities. | Non-poor |

### 1.6. IEF and Reducing Multidimensional Poverty and Inequality

An IEF framework emphasizes poverty prevention, alleviation and reduction of the gap between the haves and have nots. These objectives are accomplished through imposing obligatory charity tax (*Zakat*) or encouraging voluntary charity (*Sadaqah*) or charitable interest-free loans (*Qard Hassan*) all of which can prevent and reduce global poverty and inequality. Islamic legal system requires all Muslims to pay a portion of their surplus income as *Zakat* which can best be described as a mandatory tax levied by the *Shari'ah* on a Muslim's surplus income which is then allocated to the needy and the poor in the society. An empirical study conducted by Mohieldin et. al. (2012) suggests that, if systematically collected and distributed, *Zakat* has the potential to eradicate extreme poverty in most Muslim majority countries and reduce poverty rate significantly for others. Moreover, such a mandatory religious tax on surplus income, will reduce the rate at which wealth could be accumulated in societies governed by the Islamic law, reducing inequality rates.

In addition to *Zakat*, Islamic code of ethics highly encourages *Sadaqa* and *Qard Hassan* (Table 2) which are voluntary mechanism of addressing the financial needs of the poor and the vulnerable in the society. While such practices are "voluntary" from the *Shari'ah* perspective, when poverty is present in a society, Islamic code of ethics requires the non-poor and wealthy Muslims to do all in their power to prevent and alleviate poverty in order for them to truly adhere to the spirit of Islam. As a result, through the combination of legally mandatory charities (*Zakat*) and morally mandatory charities (*Sadaqa* and *Qard Hassan*), an IEF system possesses the necessary mechanism to do away with absolute poverty and reduce relative poverty and inequality. For instance, Shirazi (1996) noted that Zakat and Ushr transfers in Pakistan improved the disposable income of people in the lowest income brackets by nearly 40%.

In addition to the redistribution mechanism embedded in this economic and financial system, in an IEF framework, capital has no advantage to labor and the fruits of each factor of production must be distributed with fairness and according to their actual contribution and importance in the production process or their real marginal product. As a result, through the combination of its distribution mechanism according to the real marginal product of each factor of production and then its mandatory and voluntary redistribution mechanisms, an IEF system has the potential of reducing poverty and inequality globally. This is especially crucial when one considers the fact that more than 800 and 400 million of world's poor and extremely poor –defined as earning less than $4 and $1.90 PPP a day respectively– reside in Muslim majority countries.

| Table 2. The Poor, the Vulnerable, and Islamic Finance | | |
|---|---|---|
| **Financing Scheme** | **Brief Description** | **Most Appropriate Target Population** |
| Qard Hassan | It is a charitable type of loan which, in addition to being a *Qard* (interest free loan), it also contains elements of goodwill, benevolence, and generosity whereby the lender, depending on circumstance, would be willing to relax some or all terms of the loan contract including the repayment schedule. | Poor and Non-poor who are at risk of poverty if not financially supported. |
| Zakat | Mandatory transfer of small percentage of one's surplus income or capital to the poor. | Poor |
| Sadaqa | Voluntary transfer of money or any form of capital to the poor. | Poor |

### 1.7. IEF and Environmental Sustainability

Islamic teachings consider mankind as the trustee of the earth and in fact the whole creation. As a trustee, mankind is obligated to take the outmost care not to pollute the planet and deplete its resource beyond the point of replacement. In other words, any economic activity that is not environmentally sustainable in the long-run and depletes and pollutes the natural resources beyond the point of replenishment is forbidden in an IEF system. (Javadi, 2008) Environmental stewardship is taken so seriously in Islam that no excuse, including as severe as nearing of the dooms day cannot relieve mankind from this duty. In a famous prophetic narration, the prophet of Islam is reported to have said that "When doomsday comes, if someone has a palm shoot in his hand, he should plant it". Moreover, in a letter to one of his governors, the fourth caliph of the Muslims, Ali Ibn Abitalib, orders the governor to take care of the earth and the resources he is governing over and writes "Partake of it gladly so long as you are the benefactor, not a despoiler; a cultivator, not a destroyer. All human beings as well as animals and wildlife enjoy the right to share Earth's resources. Man's abuse of any resource is prohibited and be mindful that anything that leads to what is prohibited is itself prohibited, too." (Kamali, 2010; Kula, 2003; Nasr, 1992) These statements and many such more, show that Islam prohibits any economic activity that leads to the destruction of earth and its resources beyond the point of replenishment.

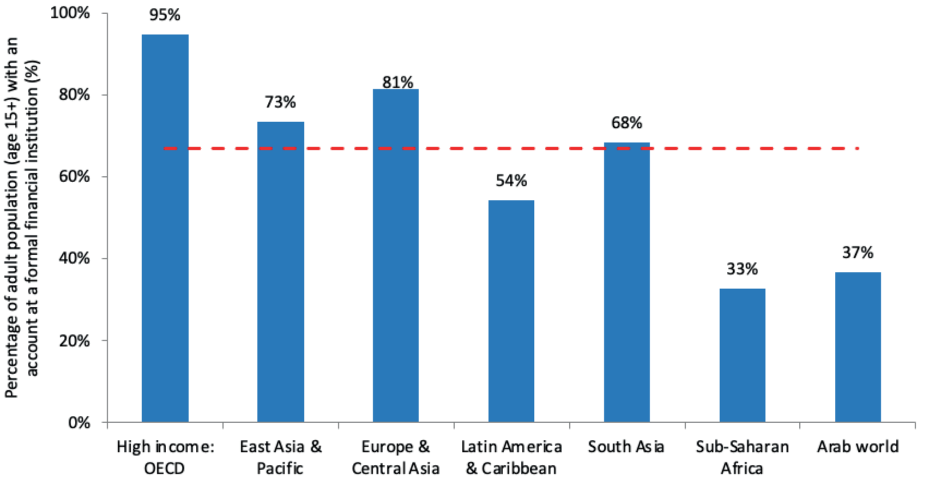
To conclude this part of the chapter, one can strongly argue that the above discussion can be strongly linked to the SDGs. More specifically, many of the SDGs are similar to the objectives outlined for a genuine IEF system; ensuring stable economic development, enhancing shared prosperity and inclusive growth, reducing multidimensional poverty and inequality, and promoting environmental sustainability and stewardship are among the common goals shared by the SDGs and an IEF system. As a result, implementation of an IEF system can be tantamount to the promotion of SDGs. Furthermore, a wide range of financial instruments available in an IEF system, some of which were mentioned earlier, have the potential to provide the financing needs of achieving SDGs. In a 2015 World Bank Working Paper, Ahmed and his colleagues provide a detailed discussion on the role of "Islamic financial institutions, capital markets, and the social sector in promoting strong growth, enhanced financial inclusion, and intermediation, reducing risks and vulnerability of the poor and more broadly contributing to financial stability and development" (Ahmed et. al. 2015, 1).

The recent global emergence and rapid growth of Islamic finance and banking industry around the world (now with assets estimated at $2.5 trillion) can contribute considerably to the stability of the global financial industry. (Askari, Iqbal and Mirakhor, 2009) The growth of Islamic finance can also increase environmental stewardship because genuine Islamic banks and financial institutions are dictated by the letter and spirit of *Shari'ah* not to finance projects that are environmentally destructive and unsustainable. Furthermore, the growth of this industry can also help reduce poverty and inequality through increasing financial inclusion which will in turn make inclusive, stable, and sustained growth more feasible and probable. Moreover, financial inclusion will make it more probable for the poorer segment of the society to gain access to the kinds of financial services that could help boost their productivity and reduce their financial vulnerabilities. Considering the importance of financial inclusion in promoting inclusive growth and reducing multidimensional poverty and inequality. (Beck, Demirgüç-Kunt, and Levine, 2004; Beck and Demirgüç-Kunt ,2008; Levine, 2005; World Bank, 2007b). The second part of this chapter will provide some initial empirical evidence on the potential role of Islamic finance in enhancing financial inclusion.

## 2. Financial Inclusion: The Role of Islamic Finance

It is estimated that more than 33 percent of the world's adult population or 1.7 billion adults don't have access to formal financial services and the majority of them reside in an emerging market and developing economies (EMDEs) (Demirguc-Kunt et al., 2018). The picture is substantially grimmer for Organization of Islamic Conference (OIC) member countries. According to Global Findex Database, more than two-third of the OIC member countries represented in this database have formal account penetration rates[4] that are less than the world average of 67 percent. The median account penetration rate among the OIC member countries is only about 30 percent, a figure that is significantly lower than the global average. Also, in comparison to other regions, the Arab world has the second lowest formal account penetration rate of 37 percent (Figure 3).

4 Account penetration rate is measured as the percentage of adults age 15 and above with account(s) in formal financial institutions.




Source: Global Financial Inclusion (Global Findex) Database.

**Figure 3.** Formal account penetration rates by regions, 2017

Furthermore, according to Global Findex, 65 percent of adults among self-identified Muslims don't have an account in a formal financial institution. In other words, about two in every five adults without a formal account around the world are Muslims. This may be one reason as to why efforts for reducing poverty or enhancing shared prosperity in many of the MENA economies and other Muslim majority countries have not been as successful as one would have wished for them to be.[5]

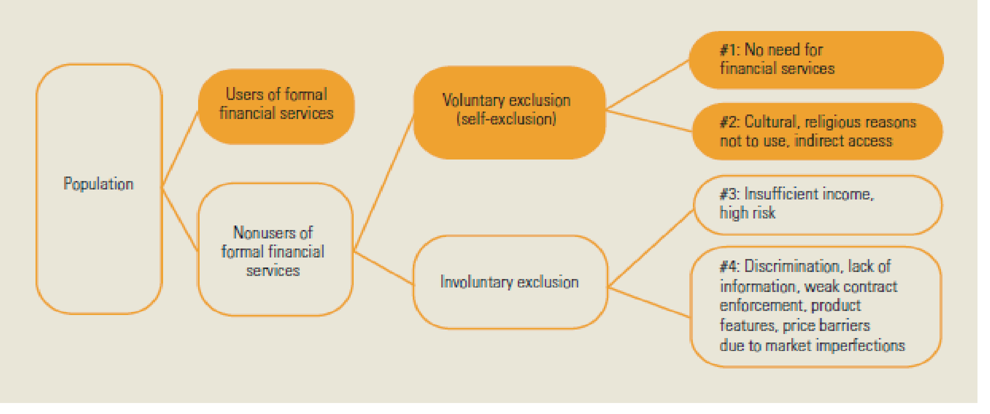
### 2.1. Reasons for Financial Exclusion

The reasons for financial exclusion, defined here as not having an account at a formal financial institution or being unbanked, are rooted in a complex set of economic, legal, social, political, cultural, and personal factors but can be classified into two main categories: voluntary and involuntary reasons. A 2011 survey, the Global Findex Database, is the first international database that makes it possible to get a first glimpse at the various aspects of financial exclusion at the individual level. In addition to many other questions, this survey asks the unbanked respondents (i.e. adults lacking a formal account) about the reason(s) as to why they do not have an account at a bank, credit union or other formal financial institution.

5 It is important to note here that while lacking an account at a formal financial institution is not always tantamount to lacking access to financial services, it is nevertheless a good proxy for measuring access to financial services. This is because most if not all forms of formal financial services are often linked to accounts in formal financial institutions. Therefore, individuals or firms without a formal account are often forced to address their financial needs through informal financial markets, which are often associated with higher costs and risks and little to no legal protection against frauds or breaches in the contract.

The respondents could choose one or more of the following reasons:

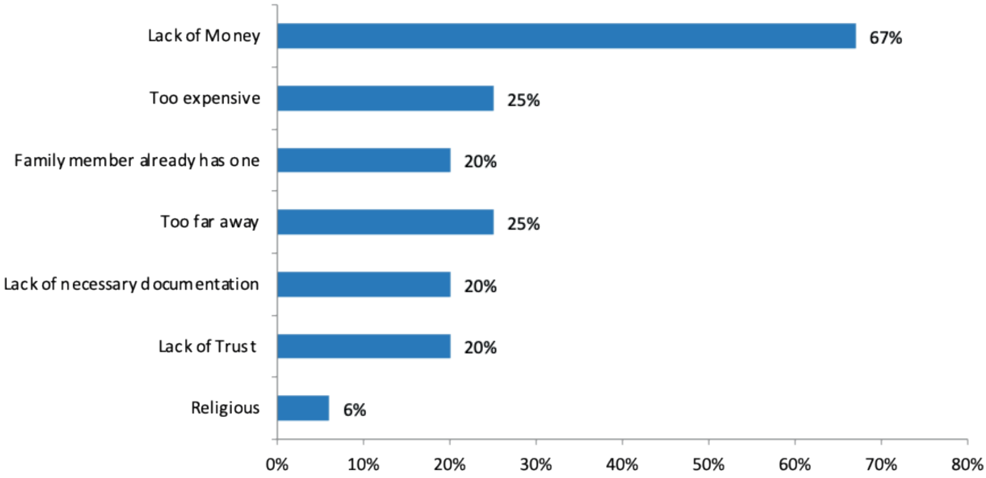
a. They are too far away.
b. They are too expensive.
c. You don't have the necessary documentation (ID, wage slip).
d. You don't trust them.
e. You don't have enough money to use them.
f. Because of religious reasons.
g. Because someone else in the family already has an account.




Source: Global Financial Development Report 2011.

**Figure 4.** Reasons for financial exclusion

This question provides a valuable entry point for analyzing the reasons for which 1.7 billion adults around the globe have remained unbanked. According to this survey, not having enough money is the most cited reason for being unbanked, followed by the cost and distance (Figure 5), while being unbanked for religious considerations is the least cited reason.



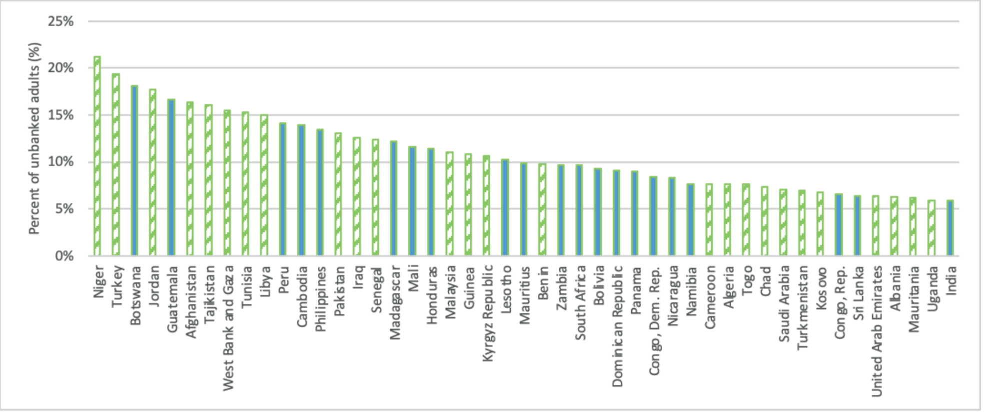

Source: Global Financial Inclusion (Global Findex) Database. Author's Calculation.
Note: Respondents could choose more than one reason.

**Figure 5.** Reasons for financial exclusion, 2017

### 2.2. Financially Excluded for Religious Reasons: Who and Where?

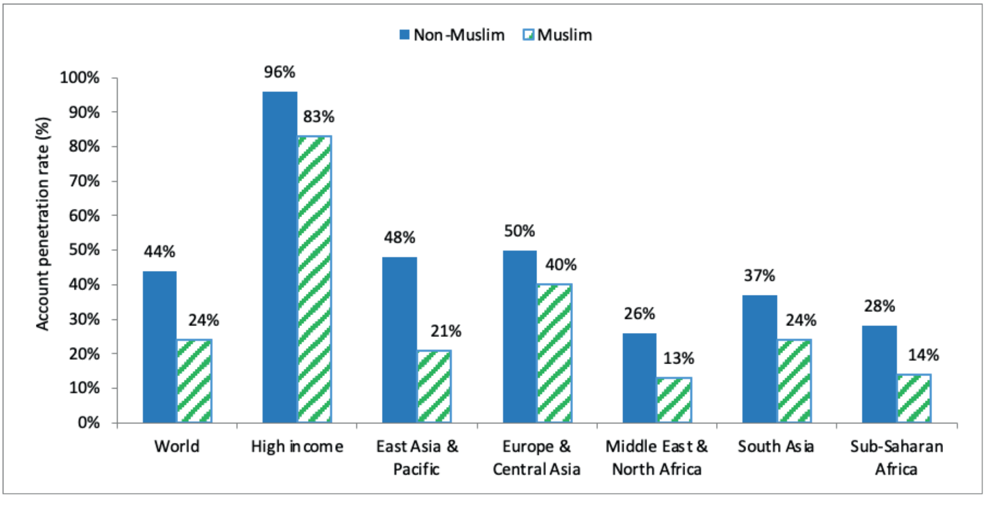
About six percent (or 102 million) of the unbanked adults around the world reported religious reasons for not having an account. But who are these adults, which religion they adhere to, and in which region and countries they reside in? A review of data shows that compared to other countries, the unbanked adults in Muslim majority countries tend to have higher likelihood of citing religious reasons for not having an account. This information in summarized in Figure 6. As evident from this figure, 28 out of 53 countries where religious reasons were cited by at least six percent of the unbanked adults are Muslim majority countries (highlighted in green patterned bars). It is important here to realize that while only six percent of adults worldwide cited religious reasons for not having an account, financial exclusion rates because of religious reasons are above 15 percent for eight OIC member countries. Furthermore, 15 OIC member countries have financial exclusion rates because of religious reasons at 10 percent or more. Overall, based on Global Findex, about 12 percent of unbanked individuals in the Arab MENA (or 17 million) and seven percent of the unbanked in OIC member countries (or 47 million) reported not having an account because of religious reasons.[6] Furthermore, Figure 7 confirms that globally, self-identified Muslims are about twice less likely to have an account in comparison to their non-Muslim counterparts (24 percent vs. 44 percent) and this gap is about 13 percentage points in the MENA region.

6 The 17 million estimate is on the conservative side as it does not include countries such as Algeria, Bahrain, Iran, Qatar, Somalia, and the United Arab Emirates, which are home to about 140 million Muslim (about 10 percent of the global Muslim population). These countries were not represented in the Global Findex Database.




Source: Global Financial Inclusion (Global Findex) Database. Author's Calculation.
Note: Green patterned bars represent OIC member countries.

**Figure 6.** Financially Excluded Due to Religious Reasons, 2017




Source: Demirguc-Kunt, Klaper, and Randall (2013).
Note: The difference between Muslims and non-Muslim is statistically significant at 1% level. Analysis is based on 64 countries. Countries with less than 1% and more than 99% Muslim population are excluded from the analysis.

**Figure 7.** Differences in financial inclusion between Muslims and non-Muslims, 2011.

## 2.3. Islamic Finance and Financial Inclusion

Cross-country regressions also support the ideas presented in tables and figures above. Regression results in Table 3[7] and a close look at changes in R-squared values between different models and the size and significance of coefficients suggests that being in the

7 All models include GDP and GDP per capita to control for different levels development in economic, legal, social, and governance fronts. This is because legal, social, and political developments are often strongly correlated with levels of economic development and the size of an economy.

MENA region followed by share of Muslim population in a given country are the most important determining factors in citing religious reasons for being unbanked.

**Table 3.** Determinant of financial exclusion due to religious reasons, 2017

| | Model 1 | Model 2 | Model 3 | Model 4 | Model 5 | Model 6 | Model 7 | Model 8 | Model 9 |
|---|---|---|---|---|---|---|---|---|---|
| GDP (2005 Billion $) | 0.000069 | 0.000311 | 0.000087 | 0.00032* | 0.00038* | 0.00139 | 0.00042* | 0.00039*** | 0.00045* |
| GDP per Capita, PPP (2005 international thousand $) | -0.0712* | -0.0123 | 0.0161 | 0.0342 | -0.0405 | -0.0903 | -0.0264 | -0.131 | -0.0598 |
| **Muslim Population (% total population)** | | **0.0942*** ** | | **0.0897*** ** | **0.0815*** ** | **0.0502*** ** | **0.0792*** ** | **0.0598*** ** | **0.0746*** ** |
| Religiosity (% adults) | | | 0.0705*** | 0.0231 | -0.0210 | -0.00780 | -0.0201 | -0.0219 | -0.0184 |
| East Asia and Pacific Dummy | | | | | -1.650 | -2.907 | -1.920 | -1.596 | -2.12 |
| Europe and Central Asia Dummy | | | | | -1.754 | -0.453 | -1.945 | -1.967 | -1.847 |
| Latin America & the Caribbean Dummy | | | | | 1.439 | 0.879 | 1.011 | 0.853 | 0.584 |
| **Middle East and North Africa Dummy** | | | | | **6.563*** | **7.342*** ** | **6.204*** | **10.325*** ** | **8.374*** ** |
| South Asia Dummy | | | | | 3.298 | -3.746 | 2.983 | 3.235 | 2.063 |
| Sub-Saharan Africa Dummy | | | | | -0.733 | -2.423 | -2.867 | -1.201 | -1.953 |
| Literacy Rate (% people 15+) | | | | | | -0.1012 | | | |
| Life Expectancy at Birth | | | | | | | -0.1320 | | |
| Commercial Bank Branches per 100,000 Adults | | | | | | | | -0.00547 | |
| Commercial Bank Branches per 1000 km$^2$ | | | | | | | | | -0.01001*** |
| Observations | 142 | 142 | 108 | 108 | 108 | 85 | 100 | 91 | 91 |
| R-Squared | 0.019 | 0.398 | 0.054 | 0.342 | 0..399 | 0.578 | 0.432 | 0.501 | 0.576 |

Note: OLS regressions with robust standard errors. * p<0.10, ** p<0.05, *** p<0.01. Dependent variable is the percentage of adults reporting religious reasons for not having an account, which is taken from Global Findex Database. GDP and GDP per capita are included in all models as proxies for the quality of institutions.

Therefore, it could be argued that enhancing the size of and access to *Shari'ah* compliant financial products can reduce voluntary financial exclusion because of religious reasons. In other words, if the earlier findings are true, one should expect to see a negative relationship between the density of *Shari'ah* compliant financial services and the percentage of adults that are unbanked due to religious reasons. Table 4 provides some evidence supporting this hypothesis. The negative and statistically significant coefficients for two different measures of density of *Shari'ah* compliant assets show that after controlling for other relevant factors, the percentages of people who report religious reasons for not having an account in formal financial institutions are lower in countries where Islamic finance has stronger presence. Put differently, one could expect that as the density of *Shari'ah* compliant assets increases, the share of unbanked people because of religious reasons would decline. This suggests that increasing the presence of and access to formal *Shari'ah* compliant financial services in countries with considerable Muslim population could reduce the level of voluntary exclusion from formal financial institutions because of religious considerations.

**Table 4.** Density of *Shari'ah* Compliant Assets and Financial Exclusion Due to Religious Reasons, 2017

| | **Model 1** | **Model 2** |
|---|---|---|
| GDP (2005 Billion $) | 0.000653*** | 0.000398*** |
| GDP per Capita, PPP (2005 international thousand $) | -0.0701* | -0.0395 |
| Religiosity (% adults) | 0.00629 | 0.0202 |
| Muslim Population (% total) | 0.0821*** | 0.0547** |
| Middle East and North Africa Dummy | 13.07*** | 12.76*** |
| Commercial Bank Branches per 1000 km2 | -0.00898** | -0.00764* |
| **Ratio of *Shari'ah* Compliant Assets to Total Assets (%)** | **-0.301*** ** | |
| ***Shari'ah* Compliant Assets per Adult (1000s $)** | | **-0.612*** ** |
| Observations | 89 | 92 |
| R-Squared | 0.631 | 0.586 |

Note: OLS regression with robust standard errors. * p<0.10, ** p<0.05, *** p<0.01. Dependent variable is the percentage of adults reporting religious reason for not having an account, which is taken from the Global Findex Database. Only those variables that were significant in at least one of the models in Table 3 were included in these regressions. *Shari'ah* compliant (Islamic) assets and total assets are from BankScope.

Furthermore, Table 5 provides some anecdotal evidence that increasing the share of *Shari'ah* compliant assets vis-à-vis total banking assets in a country can help reduce the percentage of small firms who cite access to finance as a major obstacle for their operations. This is in line with the fact that small firms are often managed and operated by members of a family, where religious considerations are more likely to surface in their financing decisions than larger firms, which are often managed by professional executives, therefore having less or no interest for *Shari'ah* compliant financing.

**Table 5.** Density of *Shari'ah* Compliant Assets and Financial Obstacles of Firms, 2017

| | All Firms | Small Firms | Medium Firms | Large Firms |
|---|---|---|---|---|
| GDP (2005 Billion $) | 0.00643 | 0.00209 | 0.00535 | 0.0142 |
| GDP per Capita, PPP (2005 international thousand $) | -0.712* | -0.703** | -0.658 | -0.509 |
| Religiosity (% adults) | 0.0453 | 0.0812 | -0.0465 | 0.0154 |
| Muslim Population (% total) | -0.0137 | -0.0484 | 0.00345 | 0.00874 |
| East Asia and Pacific Dummy | -7.276 | -5.731 | -0.602 | -15.732 |
| Europe and Central Asia Dummy | 7.131 | 9.543 | 6.783 | 4.736 |
| Latin America & the Caribbean Dummy | 2.463 | 3.601 | 5.434 | -6.092 |
| Middle East and North Africa Dummy | 13.64 | 23.40*** | 23.021 | 37.631 |
| South Asia Dummy | -3.875 | -2.844 | 3.984 | -8.647 |
| Sub-Saharan Africa Dummy | 17.981* | 22.874** | 19.872* | 0.295 |
| Commercial Bank Branches per 1000 km2 | -0.0486 | -0.283 | -0.0348 | -0.375 |
| **Ratio of *Shari'ah* Compliant Assets to Total Assets (%)** | **-0.0824** | **-0.201*** ** | **-0.412** | **-0.728** |
| Observations | 72 | 68 | 68 | 68 |
| R-Squared | 0.431 | 0.532 | 0.401 | 0.363 |

Note: OLS regression with robust standard errors. * p<0.10, ** p<0.05, *** p<0.01. Dependent variable is the percentage of firms reporting access to finance as a major obstacle in their operations, which is from World Bank Enterprise Survey. Only those variables that were significant in at least one of the models in Table 3 were included in these regressions. *Shari'ah* compliant (Islamic) assets and total assets are from BankScope.

## 3. Concluding Remarks

An IEF system advocates for the reduction of poverty and inequality and promotes an economic model with equitable and sustainable growth that ensures economic justice within and across generations, with environmental sustainability and stewardship being at its heart. (Mirakhor and Askari, 2010) Moreover, through the prohibition of *Gharar*, *Riba*, and *Maysir*, and emphasis on the real economy and PLS contracts, an IEF system is capable of promoting economic and financial stability, enhancing more equitable relationship between owners of capital and the owners labor, and focusing on sustained long-run growth and employment (Figure 10).

An important channel through which shared prosperity can be materialized is financial inclusion. According to the 2017 Global Findex Database, more than 102 million adults around the world avoid interactions with formal financial institutions because of religious reasons. Using Findex 2017 survey data, this chapter shows that Muslims are more likely to be financially excluded for religious reasons. Furthermore, Demirguc-Kunt, Klapper, and

Randall (2013), which is based on 2011 round of Findex survey, find similar results. Therefore, there is a potential role for Islamic finance in enhancing financial inclusion. In turn financial inclusion can help reduce poverty, inequality, and promote SDGs and shared prosperity among Muslim communities around the world and especially in some of the OIC member countries.

The policy implications of these finding are profound for banking officials and policymakers in OIC member countries. One important message of this chapter is for the supply side which is increasing access to Islamic financial instruments must be high on the agenda as it can help reduce voluntary financial exclusion. However, from the demand side, there is no research that identifies the characteristics of those who cite religious reasons for being unbanked. More specifically, the literature is silent on whether gender, education, age, and/or residing in urban/rural areas have any link to citing religious reasons for being unbanked. Such information can help policymakers to effectively target specific demographics in their efforts to extend Islamic financial services with the final objective of increasing financial inclusion.

Increasing awareness is an important factor in increasing demand for Islamic financial services. Examining limited sample of countries (Algeria, Egypt, Morocco, Tunisia, and Yemen), Demirguc-Kunt, Klapper, and Randall (2013) find that only "48 percent of adults say that they have heard of Islamic banks in their country that offer services to people like them" (Demirguc-Kunt, Klapper, and Randall 2013, 31). The authors also concluded that "income and access to information are strongly and positively associated with awareness and use of Sharia-compliant banking products" (Demirguc-Kunt, Klapper, and Randall 2013, 31). It is therefore crucial that supply-side policies and efforts in increasing access to Islamic financial services are complemented with demand-side strategies such as public awareness, information, and education campaigns on Islamic finance.

Serious doubts remain among the academics, policymakers, and practitioners on the role of Islamic finance in promoting financial inclusion, SDGs and shared prosperity. However, the growths and successes of *Akhuwat* in Pakistan and *Resalat Qard Hassan* Bank in Iran which are operating in accordance with Islamic social finance model of *Qard Hassan*, provide strong hope that Islamic finance can in fact help with some of the challenges facing the global community.(Mohseni-Cheraghlou, 2017) In particular, detailed case studies of *Akhuwat* and *Resalat Qard Hassan* reveal that, if implemented in ways that are in accordance with its spirit of economic justice, Islamic social finance can achieve much in the way of reducing/preventing poverty and enhancing shared prosperity while also promoting social/financial inclusion.

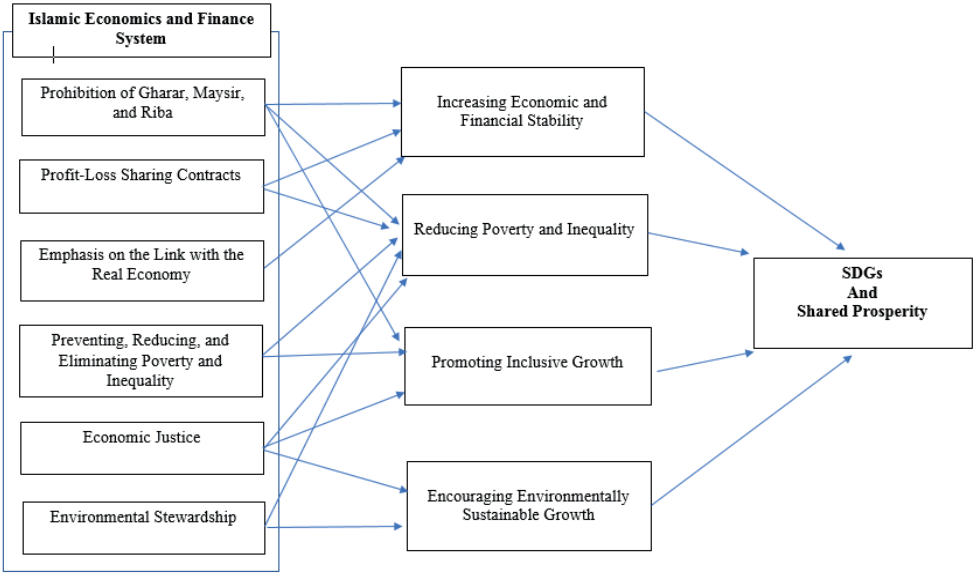



**Figure 10.** IEF, SDGs, and shared prosperity

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