LUMS | Chaudhry Nazar Muhammad Department of Economics

ROLE OF ISLAMIC FINANCE AND INFORMAL ECONOMY IN
SUSTAINABLE DEVELOPMENT

Policy Brief: April 2025

The prevalence of the informal economy, and the increasing presence of islamic financial systems have implications for sustainable development. The intended goal of having Islamic finance is to support and facilitate socially responsible investment and consequently sustainable development. This policy brief is based on research studying the impact of informal economy and Islamic finance on sustainable development using a panel dataset of 15 Muslim-majority countries from 2016 to 2022. Results reveal that Islamic finance development has a positive impact on sustainable development, while the informal economy has a negative impact on sustainable development. Furthermore, only the quantitative development/financial performance and knowledge sharing segment of Islamic finance development help to boost the development of the sector, making them potent policy tools to achieving sustainable development.

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INTRODUCTION

Informal Economy

The informal economy generally consists of small and medium-sized businesses, and refers to economic activities that are unregistered and not subject to government regulation or taxation. While the distinction between the formal and informal economic sectors is often not straightforward, it is quite evident that the informal sector (often linked to poverty) has a wide range of effects on the social and economic development of emerging and less developed countries, and has emerged as a key subject in development debate. Because of its association with unfair competition, labor rights violations, low productivity, low income, and environmental degradation, the informal sector is linked to two vicious cycles, i.e., poverty and underdevelopment. These cycles cause degradation of the environment and depletion of resources and thus, need to be tackled.

Financial Sector

The role of finance in growth and development cannot be overemphasized. The SDGs agenda has therefore prompted financial systems to review their practices and play an important role in supplementing a nation's efforts in channeling domestic public resources. This can be done through the identification of novel solutions that can deliver progress toward the attainment of sustainable development. Because efficient use of domestic resources is vital for economic growth and development, the SDGs emphasize the importance of active participation and contribution to social value creation by domestic financial market participants. Since its inception in the 1970s, Islamic finance has demonstrated significant potential to help the fulfillment of the SDGs in order to maintain environmental and human welfare.

Other Relevant Factors for Sustainable Development		
Economic Policy and Status quo	Openness to International Trade	Inflows of Foreign Capital

About this Research

While most studies have shown a positive correlation between economic growth and environmental degradation, empirical literature on the impact of Islamic finance development on sustainable development is rather limited. This policy brief is based on a research study that contributes to the literature by assessing the role of informal economy and Islamic finance on sustainable development simultaneously.

- The paper utilizes an index of Islamic Finance Development, for a panel of 15 Muslim majority countries for the time period 2016-2022, while previous studies have used only specific Islamic Finance instruments like Sukuks, Zakat etc.

- The methodology used is the FGLS (Feasible Generalized Least Squares) method for estimation, as well as quantile regression for robustness checks.

- The study's data are annual obtained from the Sustainable Development Goals Report, World Bank's World Development Indicators (WDI) database, and the Islamic Corporation for the Development of the Private Sector (ICD)-Islamic Development Bank (ISDB) Group-Refinitiv Islamic Finance Development Reports.
  - This study measures sustainable development for each country by averaging its scores on all 17 SDGs.
  - Informal economy is measured using the multiple indicators and multiple causes (MIMIC) method.
  - The Islamic finance development index is a simple average of each country's scores in 5 Islamic finance development indicators to help assess the overall performance of the Islamic finance industry in accordance with its intrinsic faith-based aims. These indicators, along with their mean scores in the data are mentioned in **Table 1.**

Table 1: Average Scores in the Muslim Majority Countries Data (2016 - 2022)	
Mean Sustainable Development Score	62.64/100
Informal Economy Share of GDP	27%
Islamic Finance Development Index	51.50/100
○ Quantitative Development	28.96
○ Knowledge	52.91
○ Governance	64.89
○ Corporate Social Responsibility	48.55
○ Awareness	65.34

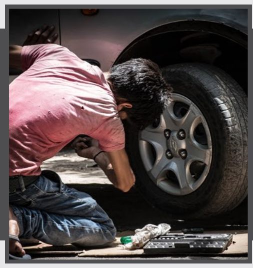
Malaysia has the highest Islamic finance development score as well as one of the highest levels of sustainable development. Likewise, Bahrain, Indonesia, and Saudi Arabia have high Islamic finance development with a high sustainable development index.

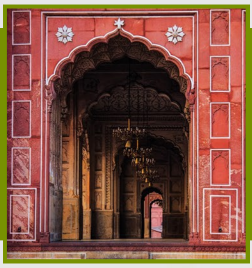
Main findings from the research are [1] :

- Higher levels of sustainable development are associated with lower levels of informal economy. Results show that an increase in informal economic activities by a percent of overall economic activities is related to a decline in sustainable development score by 0.2 points.
- Correlation between sustainable development and overall Islamic finance development score is positive. Results indicate that an increase in Islamic finance development score by one point will be associated with a rise in the sustainable development index by 0.1 points.
- Sustainable development is also positively associated with all components of Islamic finance development except the CSR/sustainability component. This implies that in general, Islamic finance development is positively related with sustainable development.
- GDP per capita, trade openness, share of foreign direct investment in GDP are positively associated with sustainable development scores, but natural resource rents are negatively correlated with sustainable development scores.

The results imply that the presence of informal economy in the studied Muslim-majority nations has perhaps resulted in lower overall productivity and hindered the existing social and environmental wellbeing due to the precarity of most informal economic activities.

Presence of the informal economy has also reduced the potential of the public sector to provide more economic and social infrastructures, as there would be tax revenue for the public sector.





Provision of funds through Islamic finance instruments and the performance of Islamic finance institutions, alongside boosting human capital with respect to Islamic finance are very vital to achieving sustainable development.

Resource-curse hypothesis: Natural resources rent has an implication for sustainable development from the viewpoint of the resource-curse hypothesis. Increase in resource rents may pave ways to corrupt practices that can circumvent the development process of an economy.

[1]The models are overall statistically significant, measured by Chi-squared stats and Pseudo-R Squared values.

POLICY IMPLICATIONS

01
Increase usage of Islamic Finance Instruments:

To help improve countries' sustainable development, the governments and regulators in Muslim-majority countries should use their regulatory frameworks to guide the operations of the Islamic finance sector in order to instill a sense of safety and credibility in the citizenry. The aim should be to boost their use of its several instruments such as the Sukuk, Takaful, and Zakat among others. Increase in the use of Islamic finance instruments is expected to boost financial performance of Islamic finance institutions and consequently help in the achievement of sustainable development.

02
Establishing Appropriate Academic Environment for thriving Islamic Finance:

The government should help provide social infrastructure that can guarantee a conducive academic environment for the establishment of institutions and platforms that can provide knowledge on Islamic finance through courses, degrees, and research outputs.

03
Addressing Regulations:

Regulations guiding Islamic finance governance should be readdressed by regulators in order to strengthen vital mechanisms to oversee Islamic finance operations.

04
Knowledge Provision and Awareness Raising:

Islamic finance practitioners can play a pivotal role in the knowledge provision aspect of Islamic finance development through investing in platforms that can render such services. This will boost countries' performance in Islamic finance knowledge indicators. They should also be actively engaged in the awareness aspect by initiating various campaigns to disseminate Islamic finance related news and organise workshops and seminars aimed at sharing information about the trends and opportunities in the Islamic finance sector.

05
Bridging the Institutions and Society gap:

Islamic finance practitioners should also put-up initiatives aimed at bringing institutions in the sector closer to the society through various social donations and contributions to their immediate environment. This will boost their corporate social responsibility and consequently, the sustainability of the operations in their environment.

DIRECTIONS FOR FUTURE RESEARCH

- Future research could investigate these relations for a broader set of countries across regions and continents.
- Given future availability of data, the scope of study can also be expanded by including more time periods.
- To further unpack the impact of informal economy and Islamic finance on sustainable development, impact on each of the 17 SDGs can also be studied in future research, to devise specific policy recommendations tailored towards achieving each goal.

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OUTLOOK SERIES

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