THE IMPACT OF VARIOUS FINANCING SCHEME IN REDUCING ECONOMIC'S INEQUALITY

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Abstract

The existence of Islamic bank not always provide positive impact to the real sector of economy. Declining inequality is one of the expected significant impacts with applying Financing Scheme as instrument to realize that. This study aims to investigate the impact of Financing Scheme was applied by Islamic bank to reduce inequality among countries of IsDB Group. World bank data and IDB data of Islamic banks are employed as samples from 1977 to 2018. The results show that equity and leasing have a positive effect and significant to reduce inequality for low-income countries, where the leasing or ijarah have the most effective impact than all. In addition, instalment sale of financing has a significant impact to reduce inequality for middle-income countries, loan is being the only significant Financing Scheme to reduce inequality in all IDB countries. Unfortunately, Mudharaba, PLS (profit and loss sharing), Murabahan and Istishna have not significantly impact to reduce inequality.

Keywords: Inequality, Islamic financing , PLS, Murabaha.

Introduction

The growth of Islamic bank in few decades show fast growing. It can be investigated from the growth of total assets which is increasing in the several years. However, the growth of Islamic bank is not necessarily able to

be the most effective solution to reduce poverty. Initially, two pillars of Islamic economic, here are PLS (profit and loss sharing) modification and Islamic social fund (ZIS) were built being a solution in the distribution of wealth, reducing inequality, and reducing poverty in the later. Moreover, this orientation is also relevant to the main goal of Islamic economic which is to give value added and maximize social welfare.

In other hand, empirical evidence shows that the instruments of Islamic bank are still far from the main goal of Islamic economic. Modification of Islamic financial and banking products have not been able to fully absorb the main objective of Islamic economic. Poverty is still be the big problem and major concern of the world (Hermez, 2014). In 2000, Global world created the project of Millennium Development Goals by purpose to eradicate poverty. MDGs was created to realize 8 global goals in 2015. Because of MDGs need to be evaluated, and to increase the participation of global world to eradicate inequality and poverty, SDGs was created to replace MDGs with 17 main goals (United Nation, 2015).

The SDGs indicator then becomes one of measurements in achieving all the main object of economic activities around the world. The existence of Islamic bank is expected to be an alternative strategy to respond the global problems related to inequality and poverty. Especially if it refers to the main purpose of Islamic economic, which is to increase added value and maximize social welfare. At the first of Islamic bank developed in 1963, which was marked by the establishment of the Mit Ghamr Bank in Egypt and then followed by others. Not only Islamic countries, now Islamic financial and banking have been widely applied by several non-Islamic countries around the world, including US, Europe, Africa, and Australia also.

Unfortunately, the existence of Islamic bank is increasingly having a bias in economy of the country. Empirical study shows that the positive impact of the Islamic bank is not able to be felt by all countries. Then the contribution of Islamic financial and banking finally need to be questioned. According to the ICD-Thomson Reuters financial report 2017 recorded that the development of sharia financial assets reached 2632 (US$ Billion), this number will continue to grow rapidly until 2020. The largest contribution of the growth of Islamic financial and banking consisting of 73% from Islamic

bank, 16% from sukuk, IFLS 6%, social fund 4% and 2% from tafakul. This growth is supported by a variety of research related to Islamic finance 2581 scientific and educational publications of 683 in 2016.

But the problem is, the contribution of the growth of Islamic financial and banking to the real economy and country is still confusing. Each of country is only preoccupied with increasing the growth of Islamic financial assets rather than to regard the impact of Islamic financial and banking to the real economy. According to this occurrence, it is clear that the impact of Islamic financial and banking is only be felt by several groups, and it can not to be investigated which is the group have got the most impact of it.

At the same time, in 2008, world bank announced that global wealth grew by around 66 percent (from $ 690 Trillion to $1.143 trillion in constant 2014 US Dollars at market prices). But in fact, inequality was substantial and persistent. as wealth per capita in high-income OECD countries was 52 times greater than in low-income countries. A decline in the number of high-income countries, some carbon-rich countries in the Middle East, and some high-income OECD countries affected by the 2009 financial crisis. Declining per capita wealth implies that assets critical for generating future growth GDP growth figures. worsened again in developing countries usually in the more dominant financial banks-based system. of course, the development of the financial system becomes the main problem in determining the income distribution of a country.

An incredibly evidence is found that Islamic financial institutions are reluctant to provide PLS Scheme (Mudharaba and Musharaka) and prefer to provide Murabaha financing mode (Farooq, 2007). Almost all Islamic banks, investment companies, and investment funds offer trade and project finance at mark-ups, commissioned manufactures, or on a rental basis. In contrary, the real and ideal financing instruments in Islamic bank is are musharaka and mudharaba. But the shocked findings show, the number of PLS financing under 20 percent of investment by Islamic bank in the world (Dar & Presley, 2000). Moreover, Islamic Development Bank as far as now not used PLS in its financial business beside in a number of small projects. In other words, it can be said that Islamic financial institutions have entered into Murabaha syndrome: a strong and consistent tendency of Islamic banks and other Islamic

financial institutions to use debt-like instruments especially in external financing.

According to the latest findings by moh'd & Abdullah (2019), the implementation of Murabaha contracts at Islamic bank with a high margin level show the controversy around the customer. It related to the problem of sharia compliance and the credibility of Islamic bank. Many opinions develop that Islamic bank is identical with conventional bank. The experience was informed us, credit system based on interest is the cause of the financial crisis in 2009. This is due to the dominance of the economy in the financial sector without regard to activities in the real sector. The dominance of financial sector will certainly lead to unhealthy economic climate, which is the activity of multiplying money is increasing without regard to the value of real commodities, in other hand, Islamic economic demands balancing between financial sector and the real sector.

The empirical implementation seriously continues to increase financial deepening, this occurrence has driven by global world. In the finding by Patric Imam & Kangni Kpodar (2015) show that the rapid growth of Islamic bank moderated by financial deepening has a positive impact on economic growth. Beside Islamic bank, Islamic micro finance also to be part to encourage financial deepening. For example, in Bangladesh, to optimize the impact of Islamic micro finance to the financial deepening increasingly inclusive. Islamic micro finance is expected to be an alternative for people who don't have access to Islamic bank. In some literatures show the development of financial sector and increased financial access in a country become a symbol of financial deepening based on the efficiency of intermediation between investors and savers (Honohan, 2004; Levine, 2005; Beck and de la Torre, 2006; Beck, Demirgüç-Kunt, and Levine, 2004 & 2007; World Bank, 2007).

Method Research

This research using a secondary data was collected from World Bank Data and Islamic Development Bank (IDB). The panel data is applied which is consisting of 50 countries from 1976 to 2018. The reason why this data is employed is, this data represents the development of Islamic bank from the period of first establishment of Islamic bank until recently. This data uses

several sources that are relevant to the required variables, this following is a description of the data:

Table 2. Empirical Strategy

Variable	Code variable	Definition	Expected sign
Control Variable			
Private Credit	IC.CRD.PRVT.ZS	Private credit bureau coverage reports the number of individuals or firms listed by a private credit bureau with current information on repayment history, unpaid debts, or credit outstanding. The number is expressed as a percentage of the adult population. (world bank definition)	
Depositors	FB.CBK.DPTR.P3	Depositors with commercial banks are the reported number of deposit account holders at commercial banks and other resident banks functioning as commercial banks that are resident nonfinancial corporations (public and private) and households.	
Commercial Bank	FB.CBK.BRCH.P5	Commercial bank branches are retail locations of resident commercial banks and other resident banks that function as commercial banks that provide financial services to customers and are physically	

Variable	Code variable	Definition	Expected sign
		separated from the main office but not organized as legally separated subsidiaries.	
Inflation	FP.CPI.TOTL.ZG	Inflation as measured by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals, such as yearly.	
lGDP	NY.GDP.PCAP.KD	GDP per capita is gross domestic product divided by midyear population. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products.	
Financing Scheme			
Murabaha	KN.M12	Project financing Islamic development bank (ISDB) to country in several sectoral distribution with scheme Murabaha contract.	
Mudharaba	KN.M7	Project financing Islamic development bank (ISDB) to country in several sectoral distribution with scheme mudharaba contract.	

Variable	Code variable	Definition	Expected sign
Equity	KN.M2	Project financing Islamic development bank (ISDB) to country in several sectoral distribution with scheme equity contract.	
Leasing	KN.M5	Project financing Islamic development bank (ISDB) to country in several sectoral distribution with scheme leasing contract.	
Loan	KN.M6	Project financing Islamic development bank (ISDB) to country in several sectoral distribution with scheme loan contract.	
Profit Sharing (Musharaka)/PLS	KN.M9	Project financing Islamic development bank (ISDB) to country in several sectoral distribution with scheme musharaka contract.	
Inequality			
GINI index	SI.POV.GINI	Gini index measures the extent to which the distribution of income (or, in some cases, consumption expenditure) among individuals or households within an economy deviates from a perfectly equal distribution. A Lorenz curve plots the cumulative percentages of total income received against the cumulative number of recipients, starting with the	

Variable	Code variable	Definition	Expected sign
		poorest individual or household.	

Data was collected from IsDB member consisting of 50 countries, then it classified based on income level by World Bank, classification is obtained as follows.

Table 3. IsDB Member Country and Income Level

Country Name	Income Level Name			
	High income	**Low income**	**Lower middle income**	**Upper middle income**
Afghanistan		√		
Albania				√
Algeria				√
Azerbaijan				√
Bahrain	√			
Bangladesh			√	
Benin		√		
Brunei Darussalam	√			
Cameroon			√	
Chad		√		
Comoros		√		
Cote d'Ivoire			√	
Djibouti			√	
Gabon				√
Gambia, The		√		
Guinea		√		
Guinea-Bissau		√		
Guyana				√
Indonesia			√	
Iraq				√
Jordan				√

Country Name	Income Level Name			
	High income	Low income	Lower middle income	Upper middle income
Kazakhstan				√
Kuwait	√			
Kyrgyz Republic			√	
Lebanon				√
Libya				√
Malaysia				√
Maldives				√
Mali		√		
Mauritania			√	
Morocco			√	
Mozambique		√		
Niger		√		
Pakistan			√	
Qatar	√			
Saudi Arabia	√			
Senegal		√		
Sierra Leone		√		
Somalia		√		
Suriname				√
Syrian Arab Republic		√		
Tajikistan		√		
Togo		√		
Tunisia			√	
Turkey				√
Turkmenistan				√
Uganda		√		
United Arab Emirates	√			
Uzbekistan			√	
Yemen, Rep.		√		

Source : isdb and world bank data

However, countries that included in this study are not only from IDB member, this shape was occurred due to Islamic Development Bank provided financing for others also, including high income countries. In this occasion, the sample size of this study developed by involving high income countries, totaling 80 countries, low-income countries, totaling 34 countries, lower middle income totaling 47, and upper middle income totaling 56 countries. This data used to enrich and increase the scale of analysis.

Data analysis that applied in this study is panel data with fix and random effect models. The reason to use this analysis based on required assumption of panel data. Hausman test used to conduct the result in attachment, then the model of this study developed in accordance with study of Beck, Demirguc-Kunt, & Levine (2007) and Shidqi (2016), as follows:

$$
\begin{aligned}
Gini_{it} = {} & \beta + \beta_1 CRE_{it} + \beta_2 DPTR_{it} + \beta_3 BANK_{it} + \beta_4 INF_{it} \\
& + \beta_5 GDP\_pca_{it} + \beta_6 MUR_{it} + \beta_7 MUD_{it} + \beta_8 EQUI_{it} \\
& + \beta_9 LEAS_{it} + \beta_{10} LOAN_{it} + \beta_{11} PLS_{it} + \varepsilon
\end{aligned}
$$

$Gini_{it}$	:	Gini coefficient on the period of year t
CRE_{it}	:	Private credit
$DPTR_{it}$	:	Depositor
$BANK_{it}$	:	Bank per 100.000 populations
INF_{it}	:	Inflation
GDP_pca_{it}	:	Economic income of a country
MUR_{it}	:	Mode financing Murabaha
MUD_{it}	:	Mode financing mudharaba
$EQUI_{it}$	:	Mode financing equity
$LEAS_{it}$	:	Mode financing leasing

LOAN$_{it}$:   Mode financing loan

PLS$_{it}$:   Mode financing PLS

e   :   Error

Some econometrics that support estimation of fixed effect report, an "Intercept", it can induce a distraction which is related to our perspective earlier that the timing demeaning eliminates all time-constant variables, including an overall intercept. Reporting of an intercept of fixed effect (FE) estimation appears from investigating α_I as parameter for estimation. Mostly, intercept that reported is average of cross-section "i" of α_I CAP. In other words, all of intercept is actually average of individual-specific intercepts, here is unbiased, a consistent estimator of $\alpha = E(\alpha_I)$. Naturally, the using of fixed effect must comply with assumptions that develop. Invariant time variable in this study is not significantly, then the fixed effect is applicable for it (Wooldridge & Jeffrey, 2012).

In the earlier studies explain, the β cap is interesting, then the equations are used to obtain these estimates. Moreover, it is usually best to view α_i as omitted variables that we control for through under transformation. α_i is generally expected to be weak. In fact, even though α_{Icap} is unbiased. it is not consistent with a fixed T as $N \rightarrow \infty$. The reason is, when we add each additional cross-sectional observation, we have to add a new α_i also. No information accumulates on each α_i when T is fixed. With larger T, we can get better estimates of the α_i, but most panel data sets are of the large N and small T variety (Wooldridge & Jeffrey, 2012).

According to Gujarati (2009), applying analyzes model of pooled data by Random effect must comply with some assumptions, here is, the number of cross-section must larger than the amount of study. The equation of random effect consisting of: e_a (residual of cross-section) and m (combined residual of time series and cross section). This model is defined as Error Components Model (ECM), because residuals consisting of two components. In addition, to elect the model between fixed effect model and random effect model, this study has to employ a Hausmann test.

Result and Discussion

In a general assumption, Islamic bank prefers to increase financial asset by Murabaha contract, in this case, murabaha was dominated the Islamic financial scheme in several countries based on income level of the countries. This following are the trends of Murabaha contracts according to the group of level income.

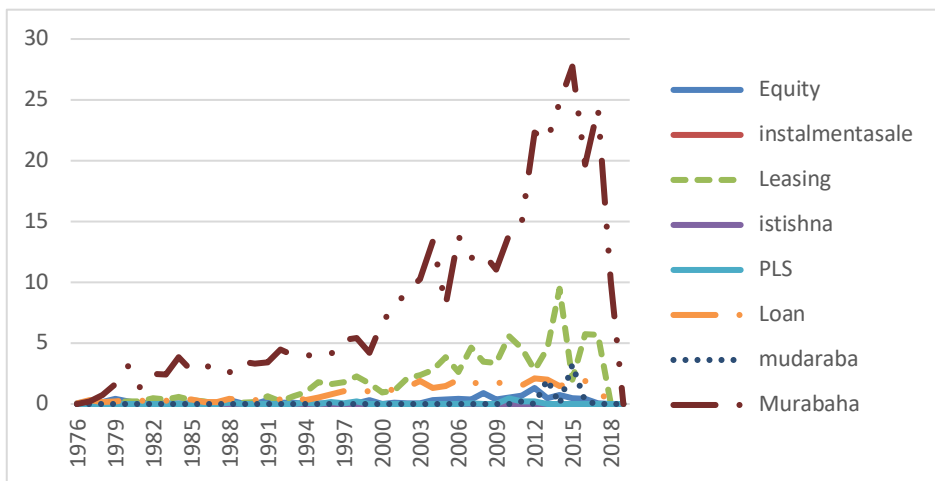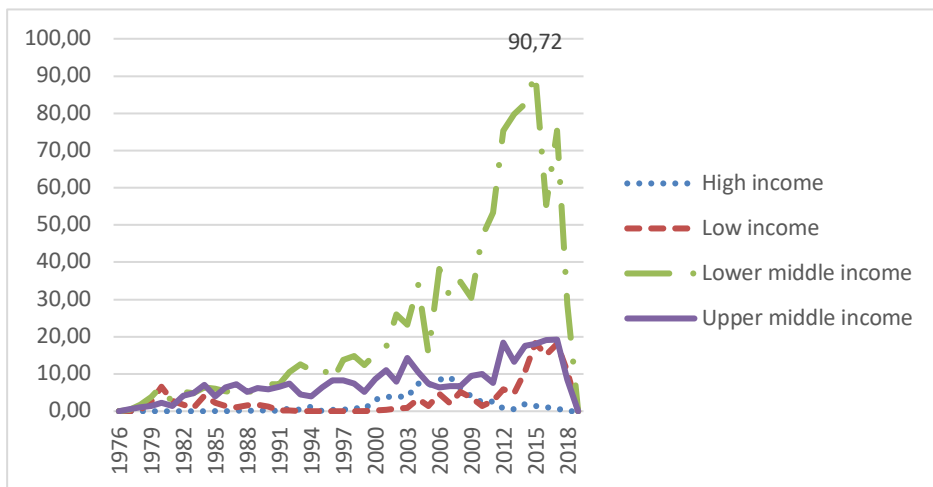### Figure 2. Financing Trend by IsDB

Figure 3. Murabaha Financing Contract Trend by IsDB

The preference of lower and upper middle-income countries to select Murabaha contract significantly increasing over time. This is affected by activities to minimize risk arising from creditors. Islamic development bank cannot be able to take a high risk from this country due to the lower and upper middle income have a high risk related to uncertainty of macroeconomic. This is a reason why Islamic development bank select to provide a Murabaha contract dominantly. This following will make it easier to understand trend relationship between gini coefficient and average of Murabaha financing.

Figure 4. Gini global and Murabahah Contract
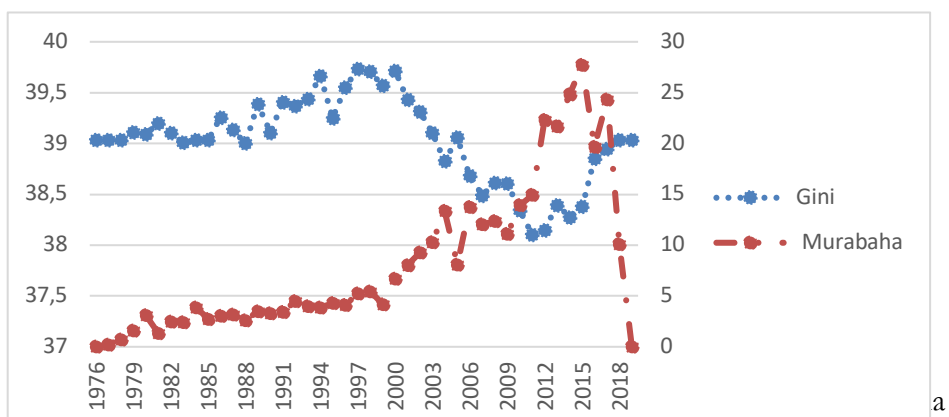
financing from 1976 to 2018. Then the relationship between of them is a convergent relationship, which is the trend of gini coefficient and Murabaha financing getting closer continuously. These results show that Murabaha financing has increased in the longer time while gini coefficient has decreased in the same time. The declining number of gini coefficient touch 38.1 %, but they are significantly increase after ever.

Descriptive Statistics

According to the income level of countries, the highest number of Murabaha financing in the lower middle income is $ 23.24 Million, and the lowest number of Murabaha financing is $ 1.68 million. Uniquely, countries that are members of IsDB have a high average Murabaha financing because the big priority of the IsDB is providing financing to the members. While the highest number of Murabaha financing for upper middle-income countries is $ 0.45 million, and the lowest number is $ 0. If only they are being members of IsDB, they will receive Murabaha financing of $ 0.54 million. So, these evidences show that Islamic Development Bank was preferred to provide debt

base financing (Murabaha) than equity base financing (mudharaba, musharaka).

In other side, the highest number of equity base financing in the upper middle-income countries is $ 0.28 million, while the lowest number is $ 0.18 million. This evidence indicate that IsDB is still put a priority to their members by number of average equity base financing around $ 0.94 million. In leasing contract based on income level, the average of highest number of lower middle countries around $3.51 million, then the lowest number for high income country around $ 1.29 million. In contrast to IsDB member countries it has a higher average of $ 5.71 million. In addition, the average of loan and PLS for low income around $ 2.99 million, and $ 0.07 million for upper middle income.

This research aims to analyze data by dynamic pooled data, that's investigated from gini coefficient fluctuation and Financing Scheme in every country. The result of Hausmann test shows, most of any models are significantly influence and fixed effect model was selected to explained this evidence, but in the last model shows a difference result, which is the result of upper middle income use GLS approach or random effect model.

Murabaha financing is the most contract was provided by Islamic Financial Institution, it occurred due to relatively easy and cheap to run this scheme. In other hand, PLS financing actually has a smaller portion compared to Murabaha, for this part is motivated by the high moral hazard that occurs in the most transactions, there are many reasons that explain, it is too difficult to apply this scheme in the large portion in Islamic financial institutions. According to Khan (1983), a differed incentive for monitoring dishonest customers can increase cost. Therefore, applying PLS financing in the Islamic financial institutions have consequences in economic losses.

Islamic financial institutions have characteristics to provide financing. In this study will try to investigate relationship between Financing Scheme and inequality by Fit-Plot. The result shows, the financing that has a great contribution to decrease inequality is the mode of equity financing. For mudharaba, they have a positive trend even if it is slow. Generally, all of financing show the decreasing trend in inequality. In the mode of Murabaha, many researchers deliberately separate from others because this is as dominant

of financing modes mostly. The Murabaha has a positive relationship. For Murabaha financing scales, there is research specializes scatter pot and fit plot itself because in this contract it has been an interesting fact. The result shows, there is a positive relationship between Murabaha financing and inequality, according to Wibisono (2018) With difficulties of profit sharing, Islamic bank turned to financing non-profit sharing like debt, murabaha with fixed and predermined returns, which can minimize risk and easy to manage it. Originally, murabaha was a general sale and purchase transaction, not a financing contract at all.

Table 4. The Result of Regression: Random Effect of Panel Data

Dependent variable: inequality (Gini index)

VARIABLES	(1) IDB Group Countries	(2) High Income Countries	(3) Low Income Countries	(4) Lower Middle Income	(5) Upper Middle Income
Mode financing					
ln_Murabaha	-0.0630*	-0.0278	-0.0211	-0.0219	-0.240***
	(0.0375)	(0.0907)	(0.0570)	(0.0790)	(0.0904)
ln_mudharaba	0.209	-0.0128	0.878**	0.722	0.0212
	(0.226)	(1.161)	(0.363)	(0.823)	(0.395)
ln_Loan	-0.191***	-0.0143	-0.0777	-0.184	-0.634***
	(0.0513)	(0.382)	(0.0563)	(0.113)	(0.172)
ln_PLS	-0.207	0.0112	0.0399	0.0523	-0.329
	(0.212)	(0.295)	(1.095)	(0.760)	(0.523)
ln_Equity	-0.272***	-0.0469	-0.110	-0.700***	-0.437*
	(0.0898)	(0.147)	(0.172)	(0.208)	(0.254)
Control variable					
Inflation	0.00251***	0.000360	3.15e-08	-0.000469**	0.000689**
	(0.000818)	(0.000784)	(7.65e-05)	(0.000231)	(0.000327)
private_credit	-0.0223***	0.00245	0.0135	0.0142**	0.00435
	(0.00533)	(0.00226)	(0.0128)	(0.00695)	(0.00440)
fb_cbk_dptr_p3	-0.000623	-0.00125***	0.000769	-0.00301***	-0.00144***
	(0.000487)	(0.000353)	(0.00115)	(0.000361)	(0.000559)
lGDP_pca	-0.194	-0.382***	0.180	-0.315	-0.374**
	(0.187)	(0.119)	(0.205)	(0.209)	(0.179)
bank_thou	0.0793***	-0.00146	-0.0368	-0.00745	-0.0384***

	(0.0127)	(0.00279)	(0.0495)	(0.0123)	(0.0122)
Constant	41.80***	39.59***	40.32***	43.60***	48.73***
	(1.448)	(1.263)	(1.291)	(1.512)	(1.619)
Observations	2,200	3,520	1,496	2,068	2,464
R-squared	0.042	0.008	0.007	0.047	
Number of countrynum	50	83	34	48	57

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

In this research model there are five models of research, the first model describes all countries that are joined in ISDB member countries, the second model is the country which is joined by lower income, the third model is the model for lower middle income and the last model is the upper middle-income model.

According to this regression, the result shows, Murabaha financing has a negative relationship with income inequality. This case already occurred in the model of IsDB group then upper middle income. This finding indicates, that Murabaha financing model based on DPC with a margin on the rate of return can have a fairness effect on the financial system. In addition, for mudharaba scheme, if mudharaba financing already applied in the low-income countries, it actually has a significant positive relationship, which if mudharaba financing is provided in the low-income countries, that is can contribute to inequality towards low-income countries. Mudharaba is a contract that provides capital from the owner of capital to the person who runs the capital, this contains a very high risk, in a country that with low income has a very high risk to invest there. So, this will have an impact on inequality, because the high investment risks are relevant with high risks that occur in mudharaba contracts. Meanwhile, natural logarithmic variables have a contribution to decrease inequality in IsDB group countries and also upper middle income. The logarithm of profit and loss sharing are not significant in reducing inequality. Logarithmic equity variables also contribute to reduce inequality in IsDB Group countries, lower middle income, and upper middle-income countries.

In other hand, control variables of this study show an interesting result, especially for IsDB group countries and upper middle income, have a positive significant relationship towards inequality. These cases indicate, if inflation that occurs in a country is getting arise, then it will also cause inequality in a country. However, this is not applicable for in lower middle countries, that is inflation shows negative relationship towards inequality. Variable of private credit has a significant positive effect in lower middle-income countries and a significant negative towards inequality in IsDB member countries. It suggests that financial deepening will have an impact on economic inequality as has been found by Hasmi (2013).

Furthermore, deposit variable shows negative relationship with inequality, the country's deposit will provide capital to those who cannot to access financing. So that inclusive finance will lead to fairness or social welfare in a country. GDP per capita shows a negative relationship to inequality, because GDP per capita has been able to provide information related to the welfare of population in a country. Then the existence of 1000 banks per 1000 population in a country is significantly positive in the IsDB group countries and negative in the upper middle-income countries. Financial infrastructure can have positive impact on economic inequality, the good infrastructures will be built in evenly in some areas, they will give positive impact for a country. But, if they are built unevenly, it will cause economic inequality in a country.

Analysis

Generally, this finding shows, that financing mode contributes to reduce inequality, but in fact, it also gives side effects toward inequality of a country. Such as mudharaba contract in lower middle countries. The implementation of policy not able be generalized. The policy maker must be wise to implement financing modes in every country, because each of them have different characteristics. This must be adapted to the needs of the country. Financing Scheme is considered very important to encourage the development in realizing social welfare. This finding confirmed the study of Razak & Wahab (2018), the theory of development by Razak & Wahab (2018), Marakhor & Bao (2013), that is Financing Scheme can raise robustness financial system, here are, can impact increasing inequality and economic fairness. In other hand, this argument disproving the study of Dixon (1992) and Kayed (2012), they suggested, Murabaha contract is considered by conventional debt financing system, or artificial Murabaha can raise injustice

to the contractor. It is clearly different as revealed by the word of god in Al-Baqarah, 275: "But Allah has permitted trade and has forbidden interest" (QS. Al-Baqarah: 275)

In the first discussion, we considered Murabaha contract/sales contract are meant to Riba, but they have different intention. The problem is, that financial deepening has a positive relationship with lower middle-income countries and IsDB member countries. This evidence will attract the big attention in all lower middle-income countries in accessing financing, so that it will reduce inequality between the rich people and the poor people. The implication for the next policy is, make the relevant financing modes for each country, we can use Islamic economic instrument to applicate this system, like zakat, waqf, infaq, and sadaqah to distribute the wealth between the rich and poor people.

Conclusion

This study shows, that Financing Scheme will impact on inequality in several countries, some of countries stated that financing modes are most important to increase inequality. However, Appling mudharaba, Murabaha, loan, and equity can decrease inequality. Then, in high income countries, financing modes is not significantly to increase inequality. In the low-income countries, applying mudharaba financing modes actually contributes to inequality. For lower middle-income countries, applying modes of financing base equity can decrease inequality, and in the middle countries, modes of financing have significant negative impact to inequality.

The policy implication of this study is, have to diversify Financing Scheme in every country due to the modification of financing is very important and will contribute to increase or decrease inequality of a country. One step how to diversify is manage every proportion of financing, involving mudharaba, Murabaha, PLS and equity must be balanced. If they have domination between others, the risk will be increased. Moreover, especially for low-income countries, lower middle and upper middle income, applying modes of financing need to more attention, because it will give impact to decline inequality of the country.

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