Do Islamic Financial Development and Institutional Quality Promote Inclusive Growth? Evidence From MENA Countries

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Article Info	Abstract
	The study aims to examine impact of Islamic financial development and institutional quality on inclusive growth in MENA countries spanning from 2011 to 2021. Panel regression model is employed to investigate the relationship. Our findings reveal Islamic financial development does not significantly affect inclusive growth due to the lack of financial accessibility and inclusivity in MENA countries. In contrast, institutional quality has a significantly positive impact on inclusive growth, suggesting the better governance can provide more opportunities to promote inclusive growth. Furthermore, we found that the combined effect of Islamic financial development and institutional quality can promote inclusive growth, highlighting the role of strong governance in effectively implementing Islamic finance for marginalized groups. The study suggests the governments should enhance governance quality and adopt inclusive policies to support Islamic finance in fostering inclusive growth.
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INTRODUCTION

The availability of underground resources (e.g oil and gas) with a potential of more than 30% of the world's total supply makes the position of Middle East and North Africa (MENA) countries in the global economic construct very vital (Hoog, 2023). World Bank (2023) reported that MENA countries have the fastest economic growth in the last decade, reaching 5.7% in 2023. However, Alazhary et al. (2021) in MENA-OECD reported that MENA faces complex challenges such as unemployment, non-inclusive labor force participation rates, low private sector development, and weak public and corporate governance. Other studies have also found that problems such as poverty and inequality, prolonged conflicts, and the climate crisis are inhibiting factors in achieving inclusive economic growth in MENA (Arogundade, 2021; Grančayová, 2023; GSMA.MENA, 2022). Inclusive economies emphasize the quality of economic growth that is not only rapid but quality sustainable and ensure equitable participation and access (Raji, 2021). Through inclusive growth, social stability, productivity, and innovation, a prosperous society can be created in the long term (Ifeakachukwu & Fagite, 2024).

An inclusive economy needs to be driven by various external and internal factors, including equitable access to finance and strengthened institutions. The financial sector builds an inclusive economy by providing more comprehensive access to various financial services, such as banking, credit, and investment (M. Ali et al., 2022). The financial sector development in MENA countries is not limited to conventional coverage. The increasing awareness of usury-free economics and the potential of a sizeable Muslim population bring new opportunities for Islamic finance. Various studies document the relationship between Islamic finance and economic growth, such as Sabiu & Abduh (2020), Naz & Gulzar (2023), and Butt et al. (2023). However, the specific role of Islamic finance in inclusive economics is still minimal. The research conducted has been limited to exploring conventional finance. As in the research, Yinusa et al. (2020) and Archer & Idun (2023) found that the financial sector can distribute capital more quickly and inclusively and reduce transaction costs and capital uncertainty to build a more equitable and sustainable economy in Africa.

The strength of institutional quality is also an essential predictor of an inclusive economy. Institutional economic theory notes that in building an equitable state economy and efforts to alleviate socio-economic problems, it is necessary to have strong and effective government institutions. This theory was introduced by Olson (1982), who states that the progress and decline of the country's economy are not only influenced by the availability of natural resources but also strongly influenced by the role of the institutions involved. Lambsdorff (2007), Menard & Shirley (2008), dan Coase (2016) then developed an understanding of this theory in a more complex framework where a combination of law, governance, contract standards, and mitigation of moral hazard such as corruption and exploitation must be integrated into a framework of political-economic institutional. The institutions in question will not only focus as regulators but also become actors in implementing the formulated economic policies.

Research conducted by Adeleye et al. (2023) and Blankson et al. (2022) found that the quality of institutions has a strong relationship with inclusive growth. This research confirms the theory of economic institutions, where institutions have a role in influencing the course of the economy. The presence of this institution will ensure that resources (wealth, human, and physical) are available to various groups of society equitably. In the context of MENA countries, research between these two variables is still limited, even though Arayssi & Fakih (2015) revealed that there is a need for in-depth exploration related to MENA Region governance considering geopolitical turmoil and low regulatory strengthening hinder development efforts. Even Emara et al. (2019) emphasized weak resource management oversight, leading to exploitation and climate crisis, especially for oil-producing MENA countries.

Ideally, the financial sector and institutional quality interact and influence each other in building an inclusive economy. Sabir (2019) revealed that strong institutional quality will encourage the implementation of finance (fiscal) policies towards an inclusive economy in Asian countries. Financial and economic inclusion in OIC countries was found by Ali et al. (2022) to have a more decisive influence if government policies and governance open up more space for innovation and expansion of financial services. Thus, economies with strong institutional quality are likely to have rule of law with effective and efficient governance (Arogundade, 2021; Olaoye & Aderajo, 2020; Sabir, 2019) equitable distribution of property rights and resources (Ifeakachukwu & Fagite, 2024; Yinusa et al., 2020) as well as market mechanisms with fair competition, which in turn will be better able to drive inclusive economic mechanisms and strengthen the role of the financial sector to create equitable access to finance.

Thus, this study will intensely explore Inclusive economic growth in selected MENA countries. The relationship between Islamic finance development, institutional quality, and their interaction with the green economy will be tested through panel data analysis, and more relevant empirical evidence will be provided. Theoretically, the results of our analysis will expand the review on the theory of institutional economics and the role of Islamic finance, which is still limited to previously researched. With this evidence, we also practically provide recommendations for policy directions to strengthen regulations on every aspect of institutions and efforts to achieve an inclusive economy that minimizes socio-economic problems. This research is also aligned with the strategy of achieving the Sustainable Development Goals (SDGs), namely zero poverty (SDG 1), economic growth (SDG 8) and reducing inequality (SDG 10), and resilient institutions (SGD 16).

METHOD
Data and Variables

This study aims to investigate the role of Islamic financial development and institutional quality in promoting inclusive growth in Middle Eastern and North African (MENA) countries from 2011 to 2021. Based on data availability, we selected Algeria, Azerbaijan, Bahrain, Egypt, Iran,

Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Sudan, Tunisia, Turkey, and the United Arab Emirates as our sample countries, thus we exclude some countries due to insufficient data for the variables used.

To address the research objectives, the dependent variable in this study is inclusive growth, measured by GDP per capita. We posit that GDP per capita serves as a representative indicator of the average welfare of a country's population. Additionally, GDP per capita captures the productive contributions of the working population, addressing issues related to poverty, inequality, and unemployment(Olanrewaju et al., 2019).

Table 1. Variable Description

Variables	Definition	Sources
Dependent Variables		
Incluisve growth (lnincg)	Gross domestic bruto per capita (US$)	WDI
Interest Variables		
Islamic Financial Development (ifd)	islamic financial development proxied by islamic finance country index	GIFR
Institutional Quality (iq)	The average value of six institutional quality indicator, namely voice and accountability (va), pollical stability and absence of violence (ps), government effectiveness (gov), regulatory quality (rq), corruption control (cc), and rule of law (rl)	WGI
Variables Control		
Foreign direct investment (lnfdi)	Net inflow foreign direct investment (US$)	WDI
Trade (trade)	Percentage merchandise trade of GDP (%)	WDI
Population (lnpop)	Total population (people)	WDI

The main independent variables in this study are Islamic financial development and institutional quality. We employ the Islamic Finance Country Index, developed by Edbiz Consulting in 2011, as a proxy for Islamic financial development. This index evaluates the achievements of countries in the context of Islamic banking and finance conditions and their leadership roles within the industry at the national and international levels. The index comprises several variables, including the number of Islamic banks, the number of Islamic banking and financial institutions (IBFIs), Shari'a supervisory regimes, Islamic financial assets, Muslim population, sukuk issuance, education and culture, and Islamic regulation and law.

Institutional quality is proxied by the average values of six indicators from the Worldwide Governance Indicators: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, control of corruption, and rule of law. Furthermore, to mitigate the issue of omitted variable bias, we incorporate several control

variables, selected based on prior research, including foreign direct investment, trade, and population.

Research Model Specification

To identify the impact of Islamic financial development and institutional quality on inclusive growth, we follow the research models of Yinusa et al (2020) and Olanrewaju et al 2019), which we subsequently modify to align with the primary objectives of this study. The basic model in this study is formulated as follows:

$$LnINCG_{it} = \beta_0 + \beta_1 IFD_{it} + \beta_i X_{it} + \varepsilon_{it} \tag{1}$$

And,

$$LnINCG_{it} = \alpha_0 + \alpha_1 IQ_{it} + \alpha_i X_{it} + \varepsilon_{it} \tag{2}$$

$LnINCG_{it}$ represents inclusive growth; IFD_{it} shows Islamic financial development; IQ_{it} represents institutional quality, encompassing six institutional indicators; X_{it} is a vector of control variables (foreign direct investment, trade, and population); ε is error term; β_i, α_1 are the estimated parameters, expected to be positive if Islamic financial development and institutional quality promotes inclusive growth; i and t denote the cross-section and time dimensions, respectively. The equation (1) and (2) is used to examine the effect of Islamic financial development and institutional quality on inclusive growth partially.

Furthermore, we also interact Islamic financial development with institutional quality to assess their combined effect on inclusive growth, expressed as follows:

$$LnINCG_{it} = \gamma_0 + \gamma_1 IFD_{it} + \gamma_2 IQ_{it} + \gamma_3 (IFD * IQ)_{it} + \gamma_i X_{it} + \varepsilon_{it} \tag{3}$$

IFD*IQ expresses the interaction term between Islamic financial development and institutional quality. The sign of coefficient γ_3 is expected to be positive, indicating that the interaction between Islamic financial development and institutional quality can stimulate inclusive growth in MENA countries.

We will employ panel data regression estimation to estimate equations (1), (2), and (3). Model selection in panel regression will be performed prior to estimating all models. The best model selection will be conducted using the Hausman test, Lagrange-multiplier test, and Chow test.

RESULT AND DISCUSSION

Table 3 provides a statistical summary of each variable used, with values before transformed to logarithms. It can be showed that the average value of inclusive growth, proxied by GDP per capita, is USD 17,832.5, with a minimum value of USD 608.33 and a maximum of USD 98,041.36. Qatar, as one of the wealthiest and most advanced countries, contributes the highest
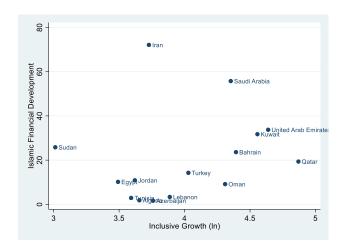
value, while Sudan has the lowest GDP per capita among MENA countries. The variable of Islamic financial development, proxied by the Islamic Finance Country Index (IFCI), reflects the development and performance of a country's Islamic financial ecosystem. A higher IFCI score indicates better performance of the Islamic financial ecosystem. The average value of Islamic financial development is relatively low, at 21.090, with a standard deviation of 22.24. The maximum IFCI value is achieved by Saudi Arabia, with a score of 80.67.
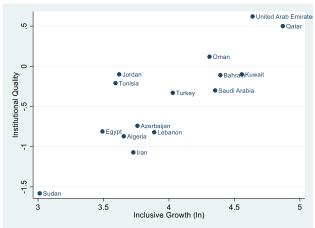
The institutional quality variable is derived from the average scores of various institutional quality indicators, where higher values reflect better institutional quality. The average institutional quality score is -0.388, with the highest value reaching only 0.68, indicating that institutional quality in MENA countries remains very low. This aligns with the findings of Awdeh & Jomaa (2022)that most MENA countries face issues of low government governance and poor institutional environments. In detail, the mean values of all individual indicators show negative scores. The highest values come from the indicators of government effectiveness and control of corruption, at 1.5 and 1.27, respectively, while the lowest values are recorded for the indicators of voice and accountability, and the rule of law. Issues in the rule of law, such as low trust in law enforcement, contribute to the decline in institutional quality in MENA (Awdeh & Jomaa, 2022).

Table 2. Summary Statistics

Variables	incg	ifd	iq	fdi	trade	pop
Mean	17832.5	21.090	-0.388	376×10^7	66.102	289×10^5
Std. dev.	20292.24	22.24017	0.58484	471×10^7	32.474	323×10^5
Min	608.33	0	-1.68	$281 \times -(10^7)$	10.202	1212077
Max	98041.36	80.67	0.68	2070×10^7	186.180	1090×10^5
Obs	165	165	165	165	165	165
			Institutional Quality			
Variables	va	ps	gov	rq	rl	cc
Mean	-1.047	-0.643	-0.071	-0.197	-0.142	-0.229
Std. dev.	0.516	0.882	0.674	0.750	0.629	0.696
Min	-1.91	-2.52	-1.66	-1.67	-1.3	-1.56
Max	0.3	1.22	1.5	1.1	0.98	1.27
Obs	165	165	165	165	165	165

Figure 1. Scatter Plot between Islamic Financial Development, Institutional Quality, and Inclusive Growth

(a) Islamic financial development and inclusive growth

(b) Institutional quality and inclusive growth

Figure 1 illustrates scatter plot between Islamic financial development and institutional quality on inclusive growth in each country, using average values for the period from 2014 to 2022. Generally, figure (a) shows that countries with higher levels of Islamic financial development tend to have higher GDP per capita, which is used as a proxy for inclusive growth. It is found that the developed countries in the MENA region tend to exhibit better Islamic financial development and inclusive growth.

Moreover, figure (b) shows a strong correlation between institutional quality and inclusive growth. This indicates that good institutional quality is accompanied by regulatory improvements that support economic growth. Similarly, developed countries in the MENA region have relatively higher institutional quality scores, which align with higher GDP per capita. This analysis underscores the importance of Islamic financial development and institutional quality in driving inclusive growth. Countries that excel in both aspects tend to exhibit better and more sustainable economic performance. Therefore, enhancing institutional quality and developing the Islamic financial sector can be effective strategies for developing countries to achieve inclusive and sustainable economic growth.

Table 3 displays the selection of the best model among the fixed effects model, random effects model, and pooled least squares. Model selection is based on the results of the Chow test, the LM test, and the Hausman test. The Chow test results indicate a probability value smaller than the significance level, for example, 5 percent, leading to the rejection of the null hypothesis (H0), and thus the fixed effects model (FEM) is chosen. Given the selection of FEM, the model can be directly subjected to the Hausman test. The Hausman test results show a probability value less than the significance level, indicating the rejection of the null hypothesis and confirming that the fixed effects model is the best model.

Table 3. The Selection of The Best Model

	FEM	PLS	REM
LM Test			275.75***
			(0.000)
Chow Test		124.81***	
		(0.000)	
Hausman Test	259.69***		
	(0.000)		

Notes: ***), **), and *) Significant at 1%, 5%, and 10% levels, respectively

Table 4. The Impact of Islamic Financial Development and Institutional Quality

on Inclusive Growth

Variables	Model 1	Model 2	Model 3
IFD	-0.0025		-0.0015
	(0.135)		(0.409)
IQ		0.2385*	0.2618**
		(0.067)	(0.045)
IFD*IQ			0.0035**
			(0.047)
LNFDI	0.0878***	0.0830***	0.0665***
	(0.000)	(0.000)	(0.003)
TRADE	-0.0067***	-0.0075***	-0.005***
	(0.000)	(0.000)	(0.003)
LNPOP	-1.0832***	-1.2719***	-0.9423***
	(0.000)	(0.000)	(0.000)
constant	25.5740***	28.8922***	23.7292***
	(0.000)	(0.000)	(0.000)
obs	153	153	153
F-test	26.72***	27.23***	220.23***
	(0.000)	(0.000)	(0.000)
R-Squared	0.4437	0.4484	0.4791

Notes: ***), **), and *) Significant at 1%, 5%, and 10% levels, respectively

Table 4 presents the estimation results for models (1), (2), and (3). The estimation results for model (1) show that Islamic financial development does not significantly affect inclusive growth in MENA. This finding can be explained by issues of financial accessibility and inclusivity in MENA countries, which prevent the potential benefits of Islamic financial development from being widely distributed. The majority of MENA countries have low financial inclusion indices, indicating poor access to financial products (Ramaian Vasantha et al., 2023). Moreover, financial development in MENA has not succeeded in reducing financial exclusion, poverty, and income

inequality, as many people still experience limited access to basic financial services (Neaime & Gaysset, 2018).

Conversely, the estimation results for model (2) provide empirical evidence that institutional quality has a significant positive effect on inclusive growth, with a coefficient of 0.2385, assuming other factors remain constant. This implies that each 1-point increase in the institutional quality index promotes inclusive growth by 0.2385 percent. This result supports the notion that good governance and institutional frameworks can produce equitable and targeted policies. This is consistent with the findings of Munir et al (2022)that higher institutional quality can expand opportunities for marginalized groups to benefit equally, thereby ensuring inclusive economic growth. Countries with strong institutional quality can reduce income inequality and poverty levels, thus promoting inclusive growth (Adeleye et al., 2023; Nawaz, 2015)

Furthermore, model (3) incorporates an interaction variable between Islamic financial development and institutional quality. Interestingly, the results show that this interaction variable significantly promotes inclusive growth. These findings are consistent with studies by Chaudhry et al (2023) and Emara & El Said (2021)). This suggests that institutional quality can support the operation and development of Islamic finance through strengthened regulations and policies. The implementation of good governance enhances transparency, accountability, and the effective implementation of Islamic finance. Improved Islamic financial development can foster financial inclusion by providing financial services to underbanked groups, including funding for micro, small, and medium enterprises. This can stimulate economic activity at the grassroots level, create jobs, and reduce poverty. Findings by Irfany et al (2022)indicate that Islamic financial inclusion can facilitate micro-enterprises in gaining wider access to Islamic financial services and products, thereby improving their businesses.

The estimation results for the control variables indicate no significant differences across all models. Foreign Direct Investment (FDI) is found to have a significantly positive effect on growth. This finding aligns with the empirical study by Rahmawati et al (2021) , which concludes that investment facilitates business expansion, subsequently enhancing employment absorption. Conversely, the empirical findings of this study reveal that the trade variable impedes inclusive growth. Increased trade competition can exacerbate income inequality and potentially lead to labor displacement in certain sectors (Bacchetta et al., 2021). Furthermore, the study also identifies a negative impact of population growth on inclusive economic development. This result is corroborated by the findings of S. Ali et al (2015) which indicate that rapid population growth can suppress investment and savings rates, as well as increase the dependency ratio. Ultimately, these conditions obstruct the path to an inclusive economy.

Table 5. The Impact of Islamic Financial Development and Indicator of Institutional Quality on Inclusive Growth

Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
IFD	-0.0024	-0.0026	-0.0029*	-0.0031*	-0.0025	-0.0029*
	(0.149)	(0.115)	(0.076)	(0.062)	(0.137)	(0.093)
LNFDI	0.0877***	0.0845***	0.07709***	0.0824***	0.0873***	0.0828***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
TRADE	-0.0067***	-0.0071***	-0.0061***	-0.0062***	-0.0067***	-0.0064***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
LNPOP	-1.0923***	-1.1114***	-1.0108***	-0.9462***	-1.0822***	-1.0125***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
VA	-0.0176					
	(0.848)					
PS		0.1181*				
		(0.064)				
GOV			0.1669**			
			(0.016)			
RQ				0.2006**		
				(0.024)		
RL					0.0105	
					(0.923)	
CC						0.1138
						(0.247)
constant	25.7102***	26.2283***	24.5943***	23.4510***	24.5943***	24.5345***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
obs	153	153	153	153	153	153
F-test	21.23***	22.47***	23.37***	23.08***	23.37***	21.70***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
R-Squared	0.4439	0.4579	0.4677	0.4664	0.4677	0.4493

Notes: ***), **), and *) Significant at 1%, 5%, and 10% levels, respectively

Based on the institutional quality indicators in Table 5, while the effect of Islamic financial development remains negative, nearly all indicators generally exhibit a positive coefficient sign towards inclusive growth. The exception is the voice and accountability indicator in model 1, which displays a negative direction. Specifically, in model 2, political stability and absence of violence are positively related to inclusive growth; ceteris paribus, an increase of one point in political stability results in a 0.1181 percent increase in inclusive growth. Political stability plays a crucial role in boosting inclusive growth by creating a conducive climate for investment (Jakšić & Jakšić, 2018; Masry, 2015) In other words, stable politics create security and enhance public trust, thus instilling confidence in the business sector to expand further.

According to the estimation results of model 3, government effectiveness has a significantly positive impact on inclusive growth, with a coefficient of 0.1669. Ceteris paribus, a one-point increase in government effectiveness is associated with a 0.1669 percent increase in inclusive

growth. An effective government can create a conducive environment for inclusive growth by designing public policies that ensure a more equitable distribution of resources. Doumbia (2019) concludes that government effectiveness is a key factor in enhancing inclusive growth by reducing income inequality and supporting pro-poor growth.

The findings of this study further confirm in greater detail that regulatory quality plays a role in fostering inclusive growth. Regulatory quality can support inclusive growth by promoting financial inclusion, competitiveness, and accommodating socio-economic conditions (Montmasson-Clair & Nair, 2015). Moreover, high-quality regulations reflect clear, transparent, and consistent rules that provide legal certainty for economic actors. Effective regulation also implies efficient oversight and law enforcement, which prevents monopolistic behavior and injustice in the economy.

CONCLUSION

The primary objective of this study is to examine the impact of Islamic financial development and institutional quality on inclusive growth in MENA countries from 2013 to 2022, using panel model estimation. Our findings indicate that Islamic financial development does not have a significant effect on inclusive growth. Conversely, institutional quality is found to have a positive and significant impact on inclusive growth, suggesting that good governance can create policies that support equity and inclusivity. In models where Islamic financial development and institutional quality are interacted, the combined effects of these variables positively promote inclusive growth, which reveals that strong institutional quality can enhance the effectiveness of implementing Islamic finance to target marginalized groups. Furthermore, other findings in this study show that almost all indicators of institutional quality have a positive impact on inclusive growth, with political stability and absence of violence, government effectiveness, and regulatory quality showing a positive and significant influence on inclusive growth in MENA countries.

Based on this research, several policy implications to promote inclusive growth in MENA countries include improving institutional quality through governance reforms, developing clear and transparent regulatory quality, and integrating Islamic finance with good institutional quality. A holistic and integrated approach is necessary to ensure that various aspects of institutional quality support each other, creating a conducive environment for inclusive growth, reducing income inequality, and supporting more equitable and sustainable economic development. However, this study has several limitations. First, we used only a single indicator to proxy inclusive growth. Future research should consider using more multidimensional indicators. Second, we employed a static panel regression method, so future studies could adopt dynamic panel methods such as GMM to address potential endogeneity issues. Third, subsequent research could expand the scope to include a broader range of Muslim-majority countries.

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