

Unlocking Inclusive Growth: The Impact of Shariah Investment in Indonesia

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Abstract

This study investigates the role of Shariah investment in Indonesia's inclusive growth. Shariah investment is measured in terms of Shariah stocks and sukuk. As determinants of inclusive growth, the study also includes several control variables adopted from separate literature, including the effect of COVID-19. In contrast to previous research, testing is conducted using a variety of inclusive growth metrics. Using principal component analysis (PCA) to compute the composite index of inclusive growth and time series regression models with monthly data at the national level from 2011 to 2022, this study finds three main conclusions. Evidence shows that Shariah investment contributes to inclusive growth in Indonesia, but the effects vary. Shariah stocks significantly affect poverty and unemployment, whereas Sukuk affects poverty and inequality. Both contributed to improving the Human Development Index (HDI) and inclusive growth. This study also revealed that COVID-19 was instrumental in reducing Indonesia's inclusive growth performance. This study complements prior empirical research on inclusive growth issues in Indonesia by examining the role of Islamic economics and finance. This research contributes to future policy initiatives to strengthen Indonesia's inclusive growth.

Keywords:

shariah investment; shariah stocks; sukuk; inclusive growth

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INTRODUCTION

A country's development achievements are linked with the level of economic growth. This assumption is understandable because economic growth is a measure that may be used to assess a country's economic performance. It is easier for a country to raise its people's living standards with positive growth. Unfortunately, economic progress does not guarantee that all people gain equality. In practice, this expansion may overlook the poor or marginalized groups, resulting in greater inequality. Inequality is a critical and strategic issue since it can potentially undermine the impact of poverty reduction efforts and the degree of growth itself. High inequality can also have an impact on political stability and social cohesion. The issue of inclusive growth has been paid attention in many countries.

Several studies have sought to define inclusive growth. Although their narratives may vary, they have generally common substantive elements. Ali & Son (2007) and Ali & Zhuang (2007) emphasize that inclusive growth involves the creation of economic opportunities through growth, which should be available to all segments of society, particularly people experiencing poverty. Inclusive growth refers to the speed and distribution of growth (Kraay, 2004; Berg & Ostry, 2017; Anand et al., 2013). Growth is inclusive if it is sustainable and effectively reduces poverty. These definitions based on that the growth process can create new economic opportunities that are not evenly distributed. Due to certain conditions or market failures, these opportunities have been limited for people with low incomes. As a result, the poor benefit less from the growth occurring than those who are not poor.

Several studies have examined the relationship between development processes in various countries and inclusive growth. UNDP (2022) stated that a decrease in low-income individuals, mortality rates, or gender gaps did not accompany the increase in economic growth in India. Crafts (1997) found that high economic growth in the UK during the Industrial Revolution was not accompanied by increased life expectancy or decreased infant mortality rates. In Indonesia, several studies indicate a phenomenon of low inclusive growth. Hayashi et al. (2014), Yusuf et al. (2014), Gonzalez & Resosudarmo (2016), and Indra et al. (2018) mentioned that economic development in Indonesia in the last one to two decades has not only been marked by improving macroeconomic performance but also worsening inequality.

According to Dartanto (2015), the declining elasticity of economic growth to poverty reduction, inequality, and unemployment throughout the 1990s and 2000s in Indonesia served as evidence of the issue of less inclusive growth. The following are some causes of this phenomenon: First, Indonesia's economy has evolved toward a more service-oriented and capital-intensive sector such as mining, finance, and telecommunications, which generates fewer job prospects, particularly for unskilled labor. As a result, people experiencing poverty need to take advantage of the benefits of an expanding economy. Second, the productivity of the industrial and service sectors is more than seven and three times that of agriculture, respectively. As a result, employees in the service and manufacturing industries benefit more than those in agriculture. In addition to these factors, inclusive growth indicators in Indonesia are also considered vulnerable to shocks.

The latest BPS data shows that during COVID-19, poverty, unemployment, and inequality rates remained stagnant or even tended to increase compared to the pre-pandemic period.

Rapid growth is required for poverty reduction (Kraay, 2004; Felipe, 2009). However, Berg & Ostry (2011) add the necessity for broad-based sector coverage and equity-based measures to create sustained, inclusive growth. Anand et al. (2013) discovered that macroeconomic stability, trade openness, investment, moderate inflation, and labor force education quality are all characteristics that contribute to inclusive growth in emerging nations. Meanwhile, the IMF (2017) highlights essential factors in driving inclusive growth, such as the role of technology (ICT), access to education, a relatively equal distribution of worker income across sectors, and financial factors (and investment), which are represented by the private sector credit-to-GDP ratio.

Investment is one of the factors that contribute to inclusive development. In general, investments deemed capable of promoting inclusive growth are those that not only stimulate the economy but also ensure that development outcomes can be distributed equitably across all segments of society. Thus, Shariah investing, which promotes the values of divinity and justice while remaining a component of the Shariah economy, can play an important role (Can, 2009). With the addition of the name Shariah to economic items such as investments, Shariah investments should have similar goals to those of the fundamental economic system. In this environment, it is anticipated that Shariah investment will contribute to economic development and more inclusive growth. This study is motivated by the possibility of Shariah-compliant investments fostering inclusive development.

A suitable approach for establishing a connection between shariah investment and inclusive growth is to examine it from two distinct perspectives: first, shariah investment as a component of general investment, and second, shariah investment as an integral element of Islamic economics and finance. In this manner, numerous theoretical and empirical literature examining the relationship between the two can be located. From the first perspective, the inclusive growth paradigm is related to the social welfare model's theoretical premise. This paradigm emphasizes the significance of public investment, as reflected in government budgets, in achieving equal access to opportunities, distribution efficiency, and wealth distribution to alleviate poverty (Blau, 2014). The Keynesian demand-side paradigm asserts that productive investment and the provision of public goods and services can stimulate aggregate demand, which can absorb labor (reduce unemployment) and stimulate growth (Easterly & Rebelo, 1993).

From the second perspective, the relationship between the Islamic economy and finance and inclusive growth can be recognized through the Islamic economy and finance's inherent risk-sharing characteristics and actual economic and financial transactions. Real sector assets and shared risk among participants—including financing institutions—support all contracts in Islamic finance. In addition, compared to conventional instruments, Islamic financial instruments are perceived to be relatively stable and more resilient to unforeseen disruptions. A second aspect of Islamic economics and finance is the promotion of economic welfare and social justice following Shariah principles. Islamic financial instruments also emphasize morality and ethics in business, respect for property rights and contractual

obligations, the pursuit of good governance, and additional social redistributive and philanthropic instruments such as zakat, waqf, and sadaqah. Due to these characteristics, the Islamic economy and finance are inextricably attached to aspects of inclusive growth.

The primary purpose of this study is to investigate the role of Shariah investment (as measured by Shariah stocks and sukuk) in inclusive growth in Indonesia. In addition to Shariah investment, this study incorporates other control factors from disparate literature as predictors of inclusive growth. This study stems from the fact that empirical studies explicitly examining the role of Shariah investment in inclusive growth in Indonesia still need to be expanded. Some similar empirical studies examining this issue in Indonesia and across countries include Ibrahim & Indra (2021), which examined the impact of Islamic products on inclusive growth in Indonesia—furthermore, Majid & Kassim (2015) investigated the role of Islamic financial institutions more broadly, including Islamic stocks, bonds, and banking, on growth. Banna & Alam (2020) analyzed the efficiency of Islamic banking for sustainable growth. Amin et al. (2015) discussed Malaysia's Islamic finance and GDP-based economic growth. Fasih (2012) examined the role of Islamic banking in inclusive growth in India.

In contrast to these previous studies, this paper implements various inclusive growth measures. Shariah investment and other potential drivers are independently regressed with inclusive growth measures such as poverty rates, inequality, unemployment, the human development index, and the inclusive growth composite index, aggregating the previously stated four variables. This strategy will likely yield a more thorough analysis and a more comprehensive range of estimation outcomes, which can explain the impact of Shariah investment and other relevant variables on Indonesia's inclusive growth. This study is expected to contribute to future policy initiatives to enhance Indonesia's inclusive growth.

The originality this research lies in its focus on exploring the relationship between Shariah-compliant investments and inclusive growth in Indonesia. While there might be existing research on Shariah investment or inclusive growth separately, this study brings a novel perspective by investigating the potential impact of Sharia-compliant investments on promoting inclusive economic growth in the context of Indonesia. This research also delves into the intersection of Islamic finance, particularly Shariah-compliant investments, and inclusive growth. This combination represents a fresh and innovative approach, as previous studies might have explored inclusive growth in conventional financial systems but not in the context of Islamic finance. The research offers policy insights by investigating the impact of Shariah-compliant investments on inclusive growth. It could shed light on how Islamic finance can be harnessed to promote economic development that benefits a broader segment of the population.

METHODS

This study applies two main methods, namely principal component analysis (PCA) and time series econometric models. Both methods utilize secondary data from various official institutions, such as the Central Statistics Agency (BPS), Bank Indonesia (BI), and

the Financial Services Authority (OJK). The main variables in this study are classified into two types: first, indicators that represent inclusive growth, namely the poverty rate, inequality, unemployment rate, and the human development index. The data were collected from the BPS. Second, indicators that represent Sharia investment, namely the Jakarta Islamic Index (JII), which represents Sharia stocks, and Sukuk, which represents Sharia bonds. Although there are various other types of Sharia investment instruments, these two are regarded as established and have expanded significantly as Sharia investment instruments in Indonesia.

In this study, the PCA method is used to create an inclusive growth index from four separate indicators: poverty, inequality, unemployment, and HDI. As a result, this study will examine five variables of inclusive growth, four of which are individual welfare indicators and one of which is the overall composite index. The use of composite indices provides an advantage in depicting the variations of inclusive growth indicators within a single indicator. PCA is a common method for creating a composite index from a set of variables that are considered to have meaningful similarities. In practice, the PCA method can be used to create a composite index by assigning different weights to its constituent indicators using data-driven approaches. PCA is designed to minimize the dimensionality of a dataset with several connected variables while keeping as much variation as feasible (Hash-Vaughn, 2017; Johnson & Wichern, 1982). Although the data is reduced in its implementation, its original features are not diminished. This technique is carried out by converting the original variables into new, uncorrelated variables. The resulting new variables are referred to as principal components.

The Principal Component Analysis (PCA) method offers several benefits and advantages in data analysis and dimensionality reduction, such as reducing the data's dimensions while still preserving the essential information. It does this by finding new variables, called principal components, that combine the original features. These principal components are chosen in such a way that they capture the most significant patterns and variances in the data. It also allows us to represent the data in a lower-dimensional space.

One of the significant advantages of PCA is its ability to help us visualize data in a more manageable and informative way. Plotting the principal components allows us to get insights into how the data points relate. This can reveal clusters of similar data points or trends that might not have been apparent in the original high-dimensional space. Moreover, PCA can help us identify and handle collinearity issues when two or more highly correlated features. It transforms these correlated features into uncorrelated principal components, which can be beneficial in various statistical analyses.

This study also employs a time series regression model to examine the influence of Shariah investment on inclusive growth indicators in Indonesia. To complete the analysis, it also includes several control variables as determinants of inclusive growth, namely the economic conditions represented by gross domestic product (GDP), the dynamics of the price level of goods and services measured by inflation, and aggregate investment measured by gross fixed capital formation. All variables were collected at the national level from 2011–2020. Given that the analysis in this study covers the COVID-19 period, the analysis will also involve the pandemic event. In this study, the pandemic impact will

be represented by a dummy variable equal to one during the pandemic period (March 2020–December 2021) and zero before the pandemic (before March 2020). Including the pandemic effect is expected to minimize bias in measuring the influence of Sharia investment on inclusive growth, as the pandemic that occurred in the first quarter of 2020 had some impact on these inclusive growth indicators.

This study employs five distinct inclusive growth indicators: poverty, inequality, unemployment, HDI, and a composite inclusive growth index that is a linear combination of the four preceding measures. Given the high levels of poverty, inequality, and unemployment, as well as the low level of HDI suggesting less inclusive growth, the HDI indicator will be expressed in the form of its inverse, with a high inverse HDI signifying a low HDI. As a result, the composite growth index comprises four indicators: poverty, inequality, unemployment, and the inverse HDI. An increasing composite inclusive growth index suggests less inclusive growth, and vice versa, based on the characteristics of its components.

Furthermore, the predictors of inclusive growth are classified into two types: main predictors, which include Sharia stocks and sukuk as Sharia investment representations, and control predictors, which include macroeconomic variables such as output level (GDP), total investment (gross fixed capital formation), inflation, and the dummy of the COVID-19 period. The model specification for measuring the impact of Sharia investment on inclusive growth metrics is expressed as follows:

$$PI_t = \beta_0 + x_t\beta_1 + z_t\beta_2 + \phi DCOV_t + \varepsilon_t \quad (1)$$

Where

- PI : The indicators of inclusive growth consist of the poverty rate, inequality rate, unemployment rate, HDI, and the composite index of inclusive growth.
- x : The vector of Shariah-compliant investment variables consists of JII (Shariah Stocks) and Sukuk (Shariah Bonds)
- y : The control variable vector consists of GDP, total investment, and inflation
- DCOV : Covid-19 Dummy; 1 if pandemic period (March 2020-December 2021) and 0 if non-pandemic period (before March 2020)

RESULT AND DISCUSSION

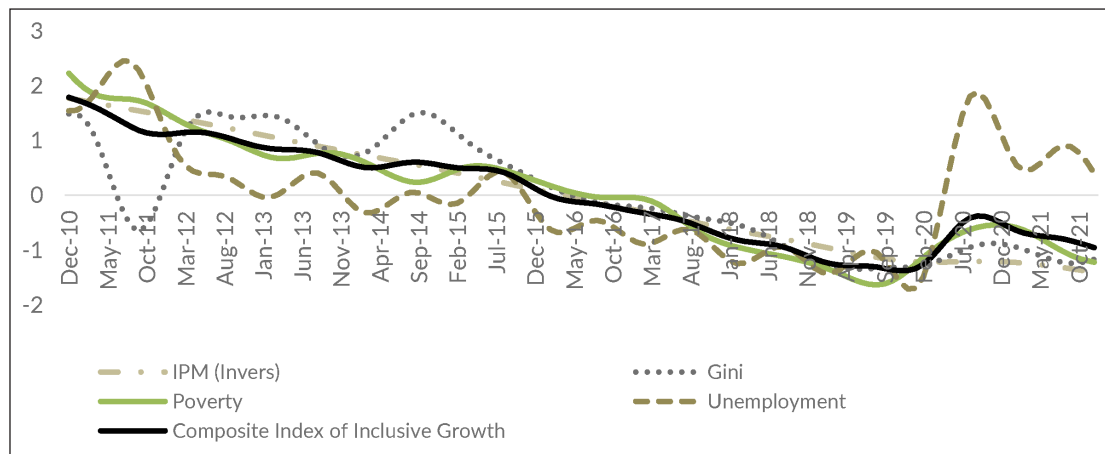
This section summarizes the four inclusive growth indicators throughout the observation period. The four indicators can be shown to have fluctuated, but their movements tend to improve from early 2011 until February 2020, or before the COVID-19 pandemic. Furthermore, during the COVID-19 era (March 2020–December 2021), the four indicators are likely to be under pressure, and some indicators, such as poverty, unemployment, and inequality, are likely to worsen.

According to BPS data, Indonesia's average poverty reduction rate was 1.76% every semester from 2011 to 2019 (pre-Covid-19). However, throughout the COVID-19 period (March 2020–December 2021), the average poverty rate climbed by 0.76% per semester. Meanwhile, the unemployment rate, which had declined by 1.45% every semester on

average before COVID-19, came under substantial pressure during the COVID-19 period. The average unemployment rate climbed by 6.29% per semester from March 2020 to December 2021, which was greater than the increase in the poverty rate during the same period. A similar picture emerged when the rate of inequality was examined. During the five years before COVID-19, the inequality rate consistently decreased with an average of 0.6% per semester. However, during COVID-19, the inequality rate tended to increase with an average increase of 0.07%. The pandemic also impacted the performance of the Human Development Index (HDI). From 2011 through 2019, the HDI grew by an average of 0.87% per year. Although the HDI could still grow positively during the COVID-19 period, its growth rate slowed to an average growth rate of 0.26%.

Indonesia's inclusive growth dynamics from 2011 to 2021 can also be observed through its aggregate indicators. This investigation utilized the PCA method, resulting in weights for each constituent indicator. The HDI variable was implemented as its inverse to facilitate comprehension of the final composite index, indicating that the higher the inverse HDI, the lower the HDI quality. This HDI transformation is intended to have the same meaning (direction) as the other three indicators: poverty, unemployment, and inequality. Consequently, a decrease or increase in the inverse HDI, poverty, unemployment, and inequality indicates improved (or worse) inclusive development quality. The composite index travels in the same direction as its constituent indices. From 2011 to the beginning of the COVID-19 era (February 2020), the composite index declined, indicating that inclusive growth in Indonesia improved. Nevertheless, the composite score tends to increase from March 2020 to the end of 2021, indicating a decline in the inclusive growth character of Indonesia.

Figure 1. Development of Inclusive Growth Indicators in Indonesia, 2011-2021



Estimates of the impact of Shariah investment on inclusive growth in Indonesia are provided in Table 1. Estimation was conducted with two distinct specifications: first, only Shariah investment variables (JII and Sukuk) were used as primary predictors and second, prospective control predictors such as GDP, total investment, inflation, and the COVID-19 dummy were included. This methodology was applied to every category of dependent variable, including poverty, inequality, unemployment, IPM, and the inclusive

growth composite index. Consequently, ten distinct estimation results will be generated. This estimation method aims to capture the influence of each predictor, particularly Shariah investment, on inclusive growth in a more complete manner.

Overall, the estimated coefficients' signs and significance align with theoretical expectations. In each estimation case, the predictor variables are found to have a significant joint effect on the dependent variable. Additionally, the predictors used in the model can adequately explain the variation in the movement of the dependent variables. This is evident from the adjusted R² values ranging from 54.6% to 98.9%. However, based on the estimation results, almost every equation suffers from autocorrelation and heteroskedasticity problems. This result is indicated by the significant values of the Breusch-Godfrey and Breusch-Pagan tests at the 5% significance level. Although the equations exhibit symptoms of autocorrelation and heteroskedasticity, as stated by Pindyck and Rubinfeld (2013), autocorrelation and heteroskedasticity only affect the efficiency of the estimates, while the parameter estimates remain unbiased and consistent. However, to avoid bias in concluding the significance level of each predictor variable resulting from these issues, the model estimation will apply Huber-White robust standard errors in each case.

Table 1 demonstrates that the estimated coefficients of JII and Sukuk are significant across various estimation scenarios. Despite divergent results, the sign of the calculated coefficients for both factors indicates that they significantly impact inclusive growth in Indonesia. This conclusion holds true in the vast majority of estimation scenarios, demonstrating that JII and Sukuk substantially impact the inclusion of control variables. Shariah stocks (JII) were found to play a significant role in virtually all development metrics, such as poverty and unemployment reduction and HDI improvement. The negative sign of the shariah stock coefficient (JII) concerning the composite index variable suggests that shariah stocks contribute to inclusive development quality. In the meantime, Sukuk contributes considerably to poverty reduction, inequality reduction, HDI improvement, and inclusive growth quality enhancement. Based on these findings, Shariah investment promotes inclusive growth to some extent. Shariah stocks contribute to all-inclusive growth metrics by reducing inequality, while Sukuk stocks contribute by reducing unemployment.

The above mentioned findings can be explained principally by positioning Shariah-compliant equities and sukuk as part of Islamic investment and finance. Sukuk is an alternative funding source for government development projects, one of which is the construction and equalization of public infrastructure. This public infrastructure development typically includes economic transportation infrastructure, education infrastructure, health infrastructure, and additional public infrastructure. The strengthening and equalization of public infrastructure contribute to increased community access, particularly for lower-income groups (including the impoverished). Therefore, they have access to facilities that provide their means of subsistence and basic requirements. In the meantime, strengthening Shariah stocks as one of the capital market's instruments contributes to the fortification and expansion of capital market-listed businesses. Expanding their enterprises will contribute to the advancement of the economy, particularly in terms of labor absorption and the creation of broader community employment opportunities.

In some aspects, the findings above confirm previous studies. Anand et al. (2013) found the role of investment represented by total investment, FDI, bank credit, and government consumption towards inclusive growth. Furthermore, studies by Hastuti (2018) and Latifah (2020) suggest that Sukuk can play a role in inclusive growth in Indonesia. Similarly, the findings of Adeosun et al. (2020) suggest that public investment can trigger inclusive growth by promoting access to opportunities through job creation and a productive labor force in African countries. The study by Osman (1991) proposed an Islamic social business model that can address market and government policy failures and, thus, poverty and inequality issues. Similarly, the studies by Ibrahim and Indra (2021) and Fasih (2012) found the role of Islamic banking in inclusive growth. The study by Kang & Martinez-Vazquez (2022) found that investment (FDI), accompanied by the strengthening of the agricultural sector, manufacturing industry, and infrastructure, plays a significant role in reducing the number of low-income people.

The estimation results in Table 1 also indicate the role of control variables in inclusive growth in Indonesia. Improved economic conditions and stability, represented by GDP level (output), total investment, and inflation stability, support the quality of inclusive growth in Indonesia. Anand et al. (2013) also found that macroeconomic stability and moderate inflation can support inclusive growth in emerging market countries. On the other hand, this study also found that the impact of the COVID-19 pandemic, which hit Indonesia in the first quarter of 2020, significantly reduced the quality of inclusive growth in Indonesia. This result can be understood because COVID-19 has heavily pressured Indonesia's economic activities. BPS data shows that from the second quarter of 2020 to the first quarter of 2021, Indonesia's economic growth (year-on-year) consistently contracted or grew negatively for four consecutive quarters. This situation, in turn, affects the socioeconomic conditions of the people. BPS recorded that the poverty rate in Indonesia increased from 9.78% in March 2020 to 10.19% in September 2020. Similarly, unemployment increased from 4.94% in February 2020 to 7.07% in August 2020. This description somewhat explains that COVID-19 has reduced the quality of inclusive growth in Indonesia.

CONCLUSION

This study found that Shariah investment promotes inclusive growth to some extent. In this study, it was found that Shariah stocks (JII) have a significant impact on all inclusive growth indicators, such as poverty and unemployment reduction, as well as the HDI. In addition, Sukuk plays a significant role in reducing poverty and inequality, bolstering the HDI, and enhancing the quality of inclusive growth. The estimation results also revealed that both variables have a substantial impact on the inclusive growth composite index. In addition, the estimation results revealed the role of control variables in inclusive growth. The stability of the economy, as measured by the level of GDP, total investment, and inflation, is one of the factors that contributes to the high quality of inclusive growth in Indonesia. This study also discovered that the COVID-19 pandemic that struck Indonesia in the first quarter of 2020 had a substantial impact on inclusive growth quality in Indonesia.

Table 1. Determinants of Capital Efficiency and Its Impact on GRDP Per Capita Growth in East Java

Variable	Composite Index of Inclusive Growth	Poverty	Inequality	Unemployment	Human Development Index
Intercept	35.77 (1.349)	6.072 (0.123)	-0.698 (0.154)	8.254 (1.046)	3.356 (0.024)
Shariah stocks	-1.861 (0.113)	-0.066 (0.019)	0.058 (0.016)	-0.183 (0.057)	0.040 (0.002)
Sukuk	-0.947 (0.049)	-0.073 (0.011)	-0.044 (0.002)	-0.036 (0.023)	0.032 (0.001)
Output	-2.616 (0.496)	-0.227 (0.066)	-0.138 (0.052)	0.368 (0.127)	0.121 (0.008)
Total Investment	-1.130 (0.472)	-0.058 (0.064)	0.042 (0.046)	-0.660 (0.149)	0.010 (0.008)
Inflation	0.049 (0.018)	0.001 (0.002)	0.002 (0.002)	0.011 (0.005)	-0.001 (0.000)
Dummy Covid-19	0.636 (0.066)	0.057 (0.008)	0.025 (0.004)	0.195 (0.020)	0.003 (0.001)
Adjusted-R2	0.913	0.921	0.777	0.824	0.989
F-Statistic	694.6	765.6	230.4	104	1705
Breusch-Pagan Stat	19.77	28.53	29.35	26.04	4.33
Breusch-Godfrey Stat	101.1	97.79	117.6	100.9	77.1

Note:

() : Standard Error

*** : Significant at 1%

** : Significant at 5%

Source: Author's Calculation Results (2023).

The fact that Shariah investment has a significant influence on inclusive growth indicators suggests that Shariah investment contributes to some extent to improving the quality of inclusive growth in Indonesia. Despite the fact that Sukuk plays a significant role in a number of inclusive growth indicators, its function in reducing unemployment rates remains limited (not significant). This situation may be explained in part by the fact that Sukuk-funded development programs are not ostensibly centered on labor-intensive, large-scale programs. Similarly, the increase in Shariah stocks, which reflects the expansion of private company enterprises, has not contributed to the reduction of inequality, although it has been shown to reduce unemployment rates.

The results indicate that corporate expansion can increase employment opportunities. However, that this expansion is still centered on specific sectors, excluding sectors with a broad equalizing influence, such as agriculture, the largest job creator. This is why Sharia-compliant equities have not yet proven effective in reducing inequality. This finding suggests that Sharia investments (Sharia stocks and sukuk) should be focused on development projects, such as public infrastructure, that seek to improve the community's access to new economic opportunities, particularly for those with lower incomes.

Additionally, inflation stability can boost the performance of inclusive growth in Indonesia. Consequently, macroeconomic stability and moderate inflation can support Indonesia's inclusive growth. This fact suggests that policymakers should increase investment and sustain economic performance by boosting productivity in sectors with the potential to generate substantial employment opportunities. Policymakers must ensure inflation stability by regulating the prices of essential commodities, which disproportionately impact the lower-middle-income population.

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