

Law and Islamic finance: How legal origins affect Islamic finance development?

Rihab Grassa ^{a,b,*}, Kaouthar Gazdar ^{c,d}

^a Higher Institute of Accountancy and Entrepreneurial Administration, ISCAE, Manouba University, Tunisia

^b LIGUE (ISCAE), Manouba University, Tunisia

^c Faculty of Economics and Management of Sousse, University of Sousse, Tunisia

^d LEFA (IHEC Carthage), University of Carthage, Tunisia

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Abstract

Many researchers have shown that differences in legal origin explain differences in financial development. Using historical comparisons and cross-country regressions for 30 countries observed for the period from 2005 to 2010, this study tried to assess if different legal origins impacted on the development of Islamic finance. More particularly, this paper tried to assess empirically why and how Shari'a Law's legal origins adopted wholly or partially (combined with Common or Civil Law) could explain the level of development of Islamic finance in different jurisdictions. Firstly, we found that countries adopting a Shari'a legal system had a very well developed Islamic financial system. Secondly, we found that countries, adopting a mixed legal system based on Common Law and Shari'a Law, were characterized by the flexibility of their legal systems to make changes to their laws in response to the changing socioeconomic conditions and that these helped the development of the Islamic financial industry. However, we found that countries, adopting a mixed legal system based on both Civil Law and Shari'a Law, were less flexible in making changes to their old laws and this thwarted the development of the Islamic financial industry in these countries. Thirdly, we found that the concentration of Muslim population (the percentage of Muslim population) had a positive effect on the development of the Islamic banking system. Also, the level of income had a positive and significant effect on the development of Islamic banking.

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1. Introduction

Over the last decade, the emergence of a considerably body of research on law and finance suggested that cross-country differences in legal origins could explain cross-country differences in financial development. One of the important factors, which could explain the financial development, was the

flexibility of laws to evolve following the emergence of the new socioeconomic circumstances (Beck, Demirgüç-Kunt, & Levine, 2003). The law's flexibility emphasized the formalism of laws and the ability of legal traditions to change. Particularly, legal systems, which adapt their effectiveness to the contracting needs of the economy, promote the development of the financial system. Whilst considerable research examined the effect of the legal system on financial development by concentrating on the effect of the origins of Civil and Common Law, few pieces of research attempted to study the effects of the legal system and especially Shari'a Law on the development of the Islamic financial system. Even if these researches

* Corresponding author. Higher Institute of Accountancy and Entrepreneurial Administration, ISCAE, Manouba University, Tunisia.

E-mail addresses: rihab_grassa@hotmail.fr (R. Grassa), kaouthar.gazdar@gmail.com (K. Gazdar).

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existed, these studies remained theoretical and no empirical research had attempted to test empirically the *Theory of Law and Finance* in the context of Islamic finance.

Nowadays, Islamic financial institutions operate worldwide (Imam & Kpodar, 2013). Being different from conventional finance, Islamic finance and the activities of Islamic financial institutions must be based on Shari'a Law. This is why the legal environment, on which Islamic financial institutions operate, can have a direct effect on the Islamic finance industry's level of development.

The worldwide different stages of development of Islamic finance drew our attention to investigating the legal origin's effect on Islamic financial development. In fact, a legal environment, which accommodates effectively the intricacies of the Islamic financial industry and facilitates its development, is crucial not only in taking the industry forward but, also, more importantly in ensuring its soundness and stability.

This paper attempts to study empirically the theory of law and finance in the Islamic finance context. More particularly, this research attempted to assess empirically why and how differences in legal system could influence the stage of development of Islamic finance. We based this study not only on making comparisons between the effects of Common and Civil Law but, also, we extended our investigation on how the origins of Shari'a legal system, adopted wholly or combined with other legal origins (specially the Civil Law and Common Law), affected the development of the Islamic finance in the concerned jurisdictions.

In order to evaluate empirically the Law and theory of financial development in the context of Islamic finance, we used cross-country regression on a sample of 30 countries. Whilst controlling for other possible determinants, we examined whether cross-country differences in Islamic financial institutions accounted for cross-country differences in legal traditions. In order to measure Islamic financial development, we used the following measures: (i) Islamic banking assets/GPD; and (ii) Islamic banking assets/total banking assets. We measured Islamic financial development over the period from 2005 to 2010. In order to measure legal origin, we used data from the CIA Factbook specifying whether the country had Common Law/Civil Law/Shari'a Law/combined Shari'a Law/Civil Law or combined Shari'a Law/Common Law.

In conducting the cross-country comparison, we controlled for other potential determinants of Islamic financial development. Specifically, we included measures of religious composition, ethnic diversity and the year of independence since 1776.

We found that: firstly, Shari'a Law had a positive and a significant effect on Islamic banking development. Since the evidence was of countries adopting a legal system based on Shari'a Law and not influenced by western countries, the legal tradition (Common Law and Civil Law) might have little impact because of institutional hysteresis. Hence, the Islamic culture could be a powerful force leading to institutional changes in and, consequently, the development of Islamic finance in these countries.

Secondly, we found that mixed Civil Law/Shari'a Law had a negative effect on the development of Islamic banking

development. This outcome could be explained by the fact that Civil Law affected adversely the positive effect of Shari'a Law on Islamic banking development. In other words, countries, adopting a mixed legal system based on both Civil Law and Shari'a Law, were less flexible in making changes to their laws and in replacing old laws with new more flexible laws which met the contractual needs of Islamic finance and which promoted the development of the Islamic financial industry.

Thirdly, we found that countries, adopting a mixed legal system based on Common Law and Shari'a Law, were characterized by the flexibility of their legal system to make changes to their evolving laws in response to the changing socioeconomic conditions which helped the development of the Islamic financial industry.

Fourthly, we found that countries, adopting a combined legal system based on Civil Law/Common Law, had a less developed Islamic financial industry than other jurisdictions. Also, these countries had weak infrastructures for Islamic financial systems.

Fifthly, we found that the concentration of the Muslim population (the percentage of Muslim population) had a positive effect on the development of Islamic banking. In addition, the level of income had a positive and a significant effect on the development of Islamic banking. Hence, rising income per capita tended to increase the number of Islamic banks in a country.

This paper contributes to the literature in several ways. Firstly, this is the first study trying to assess empirically how different legal origins impact on the development of Islamic finance, an area which continues to lag behind in the Islamic finance literature. Secondly, this paper goes much further by investigating how legal traditions shaped Islamic financial development. We did so by evaluating the robustness of the law and finance view by controlling for religion; ethnic diversity; and length of independence. This assessment seemed to be critical if we placed too much confidence in the theory of law and finance.

This paper is organized as follows. Section 2 discusses the literature review on law and finance and how Shari'a Law mattered to the development of the Islamic finance industry. Section 3 describes the data and methodology. Section 4 discusses the descriptive statistics. Section 5 discusses the regression results. Section 6 details our conclusion.

2. Literature review

Over the last decade, we observed the emergence of a large body of research discussing the legal origin's role of on financial development and how, in changing conditions, the adaptability of the legal system could explain the financial development. Adaptability of law means the aptitude of a legal system to change its way in satisfying the contracting needs of the new economic conditions which support the development of the financial system (Ahmed, 2006).

The law and finance theory argues that, over time, different countries' legal origins had influenced the evolution of their legal systems; this became a crucial determinant in analyzing

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