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Book Reviews

Shabeer Khan, *The Informal Economy and Islamic Finance: The Case of Organisation of Islamic Cooperation Countries,* New York: Routledge, 2023, 139 pages

Reviewer: Hakan Aslan

There are several solicitudes regarding the development and existence of the shadow economy, but three stand out. For starters, the operations of the shadow economy are hidden from official records, resulting in a tax loss for the government. Second, the emergence of the shadow economy indicates an erroneous connection between the government and the population. Shadow economies arise when people are dissatisfied with the government's services regarding their tax payments. The result is that losing tax revenue causes the government to encounter challenges when it comes to funding projects and development expenditures. Finally, if only official data and facts are considered, the picture of social and economic status and the entire economy will be unreliable. Due to this, workers in the shadow economy are officially classified as jobless, despite receiving compensation. This circumstance necessitates expansionary macroeconomic measures as well as additional social benefits and security expenditures (Frey & Schneider, 2000). Shadow economies have received considerable attention in developed and developing countries in recent decades, however, little research has been conducted on developing economies, particularly in Organisation of Islamic

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Cooperation (OIC) member countries. In attempting to fill the literature gap, this book makes a significant contribution.

The book, *The Informal Economy and Islamic Finance: The Case of Organisation of Islamic Cooperation Countries*, published by Routledge, and authored by Shabeer Khan, consists of eight chapters and 139 pages and was published in 2023. The book discusses definitions, rationale and theories on the shadow economy. Then, it attempts to develop a relationship between the shadow economy and Islamic finance.

Finally, the author empirically investigates the shadow economy nexus within the OIC and non-OIC countries by developing three economic models for determinants of the shadow economy, financial development and the shadow economy, and financial inclusion and the shadow economy. In the light of the fact that there are few studies on shadow economies in OIC countries, the book contributes to the empirical literature by analysing the economies in these countries from a shadow economy perspective.

In the first chapter, the author elaborates on the term “shadow economy” by providing its definition, historical background, the measurement by providing different opinions in the literature. It has been emphasised that there is neither a single definition for the shadow economy nor its measurement. This is caused by the nature of the shadow economy, which is clandestine and difficult to detect. However, As Schneider (1986) mentioned, the majority defined as follows: *“All economic activities that contribute to value added and should be included in national income in terms of national accounting conventions but are presently not registered by national measurement agencies”*. On the other hand, different naming is used in the literature for the shadow economy, such as the parallel, informal, underground, hidden, unobserved, secret, and unregistered economy (Khan, 2023). Sometimes these names are used interchangeably, but the author uses “informal economy” in his book title in line with Hart (1973)’s definition and uses mainly “shadow economy” in the manuscript. Moreover, he attempts to classify and elaborate on nuances between illegal, hidden and informal economy terminology. The chapter ends by briefly explaining the effect of the shadow economy on economic development and policies. The authors try to show the positive and negative impacts of the shadow economy according to the literature. Therefore, this chapter demonstrates introductory information about the shadow economy by explaining its definition, historical development and measurements.

The second chapter focuses on the relationship between the shadow economy and Islamic finance. Despite the shadow economy being an old concept, there has been renewed interest in it in the recent two decades. Researchers have explored it from various angles, including estimation of its size, causes, and influence on society. However, the role of Islamic finance in the shadow economy has received little attention. For this reason, the author attempts to contribute to the literature by highlighting conventional and Islamic economic perspectives on the shadow economy. The author explains brief history and fundamentals of Islamic economics and finance. The social economy practices, such as zakah, sadaqah, and qard al-hasan Islamic economics, intrinsically prevent the crowding out effect in the economy. In other words, these financing methods can help governments to include all types of businesses in the official economy. It is generally criticised that Islamic banks are ineffective in increasing financial inclusion. However, Islamic finance experts and practitioners developed Islamic microfinance and microtakaful. These two methods aim to develop abandoned parts of society. Consequently, the chapter concludes by emphasising the inadequacy of the shadow economy studies on developing countries, while many studies focus on developed and developing economies. For this reason, the author focuses on OIC member countries' shadow economies. Also, the author gives us a hint for policy recommendations from an Islamic finance perspective that can be beneficial to eradicate the shadow economy impact.

The third chapter delves into factors that cause the shadow economy. It is not easy to characterise the shadow economy because of its diverse, heterogeneous, and complex nature. The author explains its reasons: tax and social security contribution, the intensity of regulations, public sector service, official economy, and unemployment. It can be seen that the main arguments in this chapter are developed in Schneider and Enste (2000)'s study. When tax burden, social security contributions, and public expenditures are high, it pushes society into shadow economy activities. Moreover, if there is an economic downfall and unemployment in the official economy, people seek alternative solutions in the shadow economy. The authors elaborate on these reasons by providing examples of studies in this chapter. However, it has not mentioned measuring methods of shadow economy which is explained in Schneider and Enste (2000)'s study. This chapter allows readers to understand the shadow economy's main drivers.

The author gives a detailed empirical literature review in the fourth chapter. This chapter consists of three main sections. The first section discusses the determinants of the shadow economy. The author provides different opinions from various studies conducted in several countries. This section clarifies and highlights empirical justifications for the previous chapter. The author shows the relationship between financial development and the shadow economy in the second section. Most studies indicated that the shadow economy decreases with economic development, but at the initial phase, such as in developing economies, the shadow economy grows with financial development. The last section is devoted to financial inclusion and the shadow economy nexus. The author indicates that there is an inadequacy of studies on the shadow economy in OIC member countries, and it justifies this by providing an empirical literature review in this chapter. This chapter provides the author's approach to the shadow economy nexus with other economic indicators, which will be empirically analysed in the sixth chapter.

The fifth chapter explains the theoretical discussion on the shadow economy. Theoretical approaches are classified as follows dualist, structuralist, legalist, and voluntarist schools, as well as complementary theory, illegalist thought, inclusionist perspective and the modern perspective. The author claims that the shortage of empirical study on the shadow economy lacks a theoretical foundation and framework that give theoretical justification and explanation of the behaviour and nature of the shadow economy. The theoretical framework is the cornerstone for explaining any economic occurrence. It also lays the groundwork for empirical investigation. However, empirical research describing the behaviour of the shadow economy is limited due to a lack of theories. For this reason, he dedicates a complete chapter to the theoretical discussions by elaborating on each perspective of the shadow economy to ensure a better understanding. Briefly, the dualist theory asserts no relation between formal and shadow economy, while structuralists defend close relation between these two. According to legalists, the shadow economy results from overregulation in the formal economy, while complementary theory alleges that these two economies are completing each other. Voluntarists argue that shadow economy platers are selective and motivated based on their cost-benefit analysis. Illegalists do not distinguish between the shadow economy and the illegal economy. According to this theory, the shadow economy should also be considered illegal. Inclusionists state that the shadow economy is heterogenous and diversified in nature and is not open to regulations like formal economies. The modern perspective attempts to provide a universal definition for the shadow economy, and it has a holistic approach and advocates integration for all schools of thought. The author evaluates each theory from the OIC economies' perspective at the end of this chapter.

Chapter Six investigates the empirical implication of the shadow economy in OIC member countries. The sixth chapter has three sections: the first explains estimating models, the second covers methodology, and the third explains data sources and variables. The author uses three estimating models, as he classifies in the fourth chapter. He uses a dummy variable to distinguish the effect of the shadow economy between OIC and non-OIC countries. He uses 141 countries' data, 42 of which belong to OIC countries. The author employs the GMM technique, and data is limited to years between 1995 to 2015 for the first model. Then he uses data from 2004 to 2015 for the other models due to availability. He gathers data from several sources: World Development Indicator, World Governance Indicator, International Monetary Fund, World Heritage Foundation and United Nations Government Revenue Dataset.

The seventh chapter shows the findings and discussion of this empirical analysis in detail, explained in the sixth chapter. The author found that GDP has a weak but negative relationship with the shadow economy, which justifies the dualist theory. Government expenditure increment causes enhancement in the shadow economy, supported by neoclassical thought. Institutional quality is negatively related to the shadow economy, which means better institutional quality means lesser shadow economic activity. Financial development and shadow economy have a negative relationship; nevertheless, the effect is small in OIC member countries. This is explained as the majority of the OIC member countries are developing countries; for this reason, the effect is minor. Lastly, financial inclusion is negatively related to the shadow economy, and the effect is lesser in the OIC countries. This is explained as most of the OIC member countries are Muslim; however, their financial system is not fully Shariah compliant. This can cause voluntary financial exclusion. The last finding was only Islamic finance interpretation from the empirical analysis.

The last chapter provides brief conclusion and policy recommendations. The author summarises his findings. He found that institutional quality, financial development and financial inclusion have a negative relationship with the shadow economy. He suggests that policymakers consider these implications during economic planning and institutional development. One crucial missing link is that the author did not clearly explain the relationship between the shadow economy and Islamic finance. The book ends with appendices which provide detailed tables and figures for those interested in the details of the econometric analysis.

The informal economy has distinct characteristics, nature, drivers, and scale in various nations. While substantial studies have been performed on developed economies, developing countries, notably those in the OIC, have received less attention. This book is a pioneering study that delves into the Islamic financial viewpoint on the informal economy in the case of OIC countries. It thoroughly covers many definitions, historical development, kinds, and determining elements of the shadow economy, giving light on the reasons for people's proclivity to join in and remain in the informal sector. The book also carefully investigates other hypotheses, offering a more in-depth understanding. Generally, the book is well-structured and has a good flow. The empirical analysis and representations of findings and explanations are pretty solid. However, it could be better to provide a theoretical framework before an empirical literature review by changing the fourth and fifth chapters. It might have a better flow. Although the title is the informal economy, the author uses shadow economy throughout the entire text. However, it would be a better fit to use shadow economy in the title, considering his taxonomy of the terminology in the book (Khan, 2023, p.16). Furthermore, findings and discussions seem weak in developing a relationship between empirical findings and Islamic finance. Although chapter two suggests some policy recommendations from an Islamic finance perspective, it has not been mentioned in the seventh and eighth chapters. According to the title, more Islamic finance discussions are expected. Overall, the book fills an essential gap in the empirical literature on the shadow economy and developing country nexus. Considering these facts, the books provide important insights for researchers, students and policymakers interested in development economics, public policy, and the shadow economy.

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