

Role of Islamic Microfinance in Poverty Reduction

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Abstract

In recent years, Islamic finance has received a great deal of interest as an alternative financial system that emphasizes ethics and social responsibility. Providing financial services to the poor is central to Islamic finance's mission to foster economic growth and lessen social inequality. Profit and loss sharing, asset-based lending, and risk-sharing arrangements are only some of the financial products and services available through Islamic finance. By adhering to these guidelines, lenders and borrowers can rest assured that their financial dealings are conducted in a fair and honest manner. Zakat (charitable giving), Waqf (endowments), and Qard al-Hasan (interest-free loans) are just a few of the social financing solutions available through Islamic finance that are designed to help the most disadvantaged sections of society. These goods do more than only aid the poor financially; they also foster community and lessen financial hardship. Being an ethical and socially responsible financial system that encourages economic growth and financial inclusion, Islamic banking plays an important part in alleviating poverty. Islamic finance can help people accomplish the objective of ending

poverty, by encouraging fair and environmentally responsible financial practices.

Keywords: Poverty, Islamic finance, Risk Sharing, Zakat, Social Responsibility

Introduction

A financial system that is based on the principles of Islamic law (Shariah) is known as Islamic finance. These principles ban usury (riba) and encourage risk-sharing, fairness, and social justice. Contracts based on profit and loss sharing (PLS), one of the many tools made available by Islamic finance, can be utilized to fight poverty and advance economic growth. The provision of microfinance services is one of the most significant ways in which Islamic finance can assist to the alleviation of poverty. Poor people, especially women, who are unable to access regular banking services owing to a lack of collateral or credit history can receive loans from Islamic microfinance organizations (MFIs), which are also known as "microfinance institutions." PLS contracts, such as Mudarabah and Musharakah, are utilized by Islamic MFIs in order to distribute the financial burdens and benefits of the enterprise among the borrowers. (Ali, M. (2018)¹.

Through its emphasis on philanthropy and social welfare, Islamic finance can also help alleviate poverty. One of the five pillars of Islam is zakat, which mandates monetary contributions from Muslims to those in need. Zakat is a form of charity that is collected and distributed by Islamic financial organizations to help finance social welfare programs and fight poverty. (Ariff, M., & Rosly, S. A. (2012)². By making capital available to micro, small, and medium-sized businesses, Islamic finance can contribute to more equitable economic expansion (SMEs) (Hassan, M. K., & Lewis, M. K. (Eds.). (2007)³. To help SMEs and encourage entrepreneurship, Islamic finance provides alternative financing options like equity financing and venture capital. (Khan, F. (2014)⁴. In general, Islamic financing has a substantial impact on inclusive economic growth and the alleviation of

poverty. (Siddiqi, M. N. (2008)⁵. To completely comprehend the effect of Islamic financing on poverty alleviation, further research and empirical evidence are still required.

Poverty

Lack of access to the resources, opportunities, and skills required to live comfortably is referred to as poverty. (Alkire, S., & Foster, J. (2011)⁶. It is a multifaceted notion that includes social isolation, susceptibility to shocks and dangers, as well as poor income and restricted access to social services, housing, healthcare, and education. (Anand, S., & Sen, A. (2000)⁷. Poverty can be assessed in a number of ways, such as through income-based metrics, multidimensional metrics, and subjective metrics. (United Nations Development Program. (2020)⁸. Income-based measurements often utilize a poverty line or threshold to quantify the percentage of persons who earn less than what is necessary to meet their basic necessities. (Chen, S., & Ravallion, M. (2010)⁹. The percentage of people who experience deprivation in one or more of these areas is measured using multidimensional measures, which also take into consideration other aspects of poverty, including health, education, and living conditions. Subjective assessments gauge people's pleasure with life and availability to necessities based on their opinions of their living standards. (Ravallion, M. (2016)¹⁰.

Problems raising from poverty

Poverty can lead to a cycle of deprivation and exclusion since it is linked to a number of social, economic, and health issues. Among the issues brought on by poverty are: Poor health outcomes: Poor health outcomes, such as increased rates of malnutrition, infectious infections, mental illness, and maternal and infant mortality, are associated with poverty. (Krieger, N. (2017)¹¹. People in poverty may experience worse health issues due to poor living conditions, restricted access to healthcare, and a lack of information and awareness. (Lloyd-Sherlock, P. (2017)¹². Limited access to education: Children who are living in poverty may not be able to attend school or finish

their education, which may limit their chances and keep them stuck in the cycle of poverty. Low literacy rates, a lack of sufficient job skills, and lower earning potential can all result from inadequate educational opportunities. (McLoyd, V. C. (1998)¹³. Social exclusion: Social exclusion and prejudice brought on by poverty can impede social mobility and prolong marginalization. Those who are poor may experience humiliation, loneliness, and hopelessness as a result of social marginalization. (Rein, M. (2018)¹⁴. Economic insecurity: Economic insecurity, which includes difficult access to credit, heavy debt loads, and susceptibility to shocks and crises, is linked to poverty. Since it prevents people from taking chances or making investments in their future, economic instability can prolong poverty. Political instability: By escalating social tensions, weakening public confidence in the government, and fostering an environment conducive to conflict and violence, poverty can contribute to political instability. (Sassen, S. (2014)¹⁵.

Islamic financial system

Islamic finance is a fast-expanding industry that follows Sharia law and is founded on Islamic principles. In contrast to traditional finance, this system is distinct since it forbids interest-based financing and instead relies on profit-and-loss sharing (mudarabah), cost-plus financing (murabahah), leasing (ijarah), and other non-interest-based financing techniques. (Khan & Ahmed, 2018)¹⁶. The idea of risk-sharing is one of the fundamental tenets of Islamic banking. This theory is founded on the notion that, unlike conventional finance, where the lender bears all the risk, gains and losses should be shared between the lender and the borrower. (Iqbal & Mirakhor, 2011)¹⁷. By stimulating investment and entrepreneurship and ensuring a more equitable allocation of risk and reward, this strategy fosters economic growth. The idea of zakat, which is a required charitable payment that Muslims must make in order to aid the poor and in need, is a key component of Islamic finance. This charitable giving mechanism is an essential component of Islamic finance and aids in advancing social justice and reducing poverty. (Hussain &

Hassan, 2018)¹⁸. Many financial organizations around the world provide shariah-compliant goods and services, making Islamic banking a rapidly expanding business. Islamic finance has gained acceptability throughout the world in recent years, not just in nations with a majority of Muslims. (Khan & Ahmed, 2018).

I. The concept of risk sharing

The idea of risk-sharing, which is founded on the idea that both the lender and borrower share the risk and benefit of an investment, is one of the characteristic aspects of Islamic finance. Islamic financing encourages a more equitable allocation of risk and reward than conventional finance, where the lender assumes all of the risk and is promised a fixed return in the form of interest. (Iqbal & Mirakhor, 2011). Islamic finance can be practiced in a number of ways that are founded on the idea of risk sharing. A profit-and-loss sharing arrangement between an investor (rabb al-mal) and an entrepreneur is called *mudarabah* (*mudarib*). In this scenario, the investor supplies the money while the entrepreneur runs the company. Losses are carried by the investor, while profits are distributed in accordance with a predetermined ratio. (Khan & Ahmed, 2018)¹⁹. *Musharakah*, which is a partnership between two or more parties who share both the capital and administration of a project, is another type of Islamic financing that involves risk sharing. The partners split profits and losses based on their respective efforts, and the partnership can be terminated once the project is complete. (Iqbal & Mirakhor, 2011)²⁰. By enticing investors to take a more active part in managing their investments and enabling entrepreneurs to access capital without the burden of interest-based financing, the risk-sharing principle in Islamic finance encourages entrepreneurship, investment, and economic growth. (El-Gamal, 2006)²¹.

2. The concept of zakat

One of Islam's five pillars, *zakat* is a required charity payment made by Muslims to help the needy and the destitute. The notion of *zakat* is based on

the principle of sharing riches with those who are less fortunate. The word "zakat" signifies "purification" and "development." (Hussain & Hassan, 2018)²². Zakat is computed as a percentage of a person's wealth, usually 2.5%, and is not regarded as a tax but rather as a kind of worship. Eight kinds of recipients receive it, including the needy, the underprivileged, and those who are in debt. (Kuran, 2004)²³. Zakat has social, economic, and spiritual value in addition to these. Zakat contributes to social justice by facilitating the distribution of income and resources, which in turn helps to combat poverty and injustice. (Hussain & Hassan, 2018)²⁴. Zakat is a crucial component of the Islamic financial system because it encourages morality and social responsibility. (Iqbal & Mirakhor, 2011)²⁵. Many organizations, including mosques, charities, and governmental organizations, collect and disperse zakat. With the creation of zakat funds and other shariah-compliant investment vehicles, there has been an increase in interest in integrating zakat into the established financial system in recent years. (Khan & Ahmed, 2018)²⁶.

Role and potential of Islamic finance in poverty reduction

Islamic finance has the potential to significantly contribute to the fight against poverty, especially in nations where these issues are pervasive. Some of its crucial functions include:

I. Emphasis on social responsibility and ethical behavior

Islamic financial practices are centered on morality and social responsibility. The main principles of Islamic finance, such as the ban on *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling), aim to encourage fairness, transparency, and stability in financial dealings. (Hassan & Lewis, 2007)²⁷. Islamic finance differs from conventional finance in that it places a strong emphasis on moral conduct and social responsibility, which has the ability to support long-term economic growth. (Kettell, 2011)²⁸. Through the notion of zakat, Islamic finance actively encourages morality and social responsibility. One of the five pillars of Islam is the obligation of Muslims to give zakat, a

mandatory charitable donation. Zakat, which is often estimated as a proportion of a Muslim's wealth, is used to fund a variety of social welfare initiatives, including efforts to combat poverty, advance education, and provide healthcare. (Hussain & Hassan, 2018)²⁹. Zakat institutions, which are either independent NGOs or government organizations, are in charge of zakat collecting and distribution. Islamic banking also encourages moral behavior and social responsibility by placing a strong emphasis on risk-sharing. Islamic banking promotes a spirit of partnership and shared responsibility by encouraging lenders and borrowers to share risks and profits. (Archer & Abdel Karim, 2011)³⁰. Unlike to conventional finance, which is frequently characterized by an imbalance of risk, with lenders bearing the majority of the risk, this method does not assume any risk.

Moreover, social justice and environmental sustainability are highly valued in Islamic finance. For instance, shariah-compliant investments are necessary to prevent holdings in sectors like cigarettes, gambling, and armaments that harm society or the environment. (El-Gamal, 2006)³¹. Additionally, Islamic banking promotes the utilization of profit-sharing agreements like *mudarabah* and *musharakah*, which foster shared accountability and can serve to lessen wealth inequality. (Hassan & Lewis, 2007). In conclusion, Islamic finance plays a variety of roles in social responsibility and ethical behavior, including promoting zakat, risk-sharing, environmental sustainability, and social justice. Islamic finance has the ability to support a more just and equitable society by upholding these ideals, as well as sustainable economic growth.

2. Promoting financial inclusion

The provision of inexpensive and accessible financial services to people and businesses, particularly those who are underserved or excluded from mainstream financial systems, is referred to as financial inclusion (CGAP, 2020). Islamic finance, which is founded on social justice and the equitable distribution of wealth, has the potential to be a significant force in advancing financial inclusion. The idea of *mudarabah* is one of the main ways Islamic

banking encourages financial inclusion. A manager and an investor (rab al-mal) enter into a profit-sharing agreement known as a mudarabah (mudarib) (Khan & Ahmed, 2018)³². According to this approach, the manager operates the business while the investor provides the funding. The two parties then divide the proceeds in accordance with a previously decided ratio. Mudarabah makes it possible for people to get finance even if they lack the resources or know-how to launch a business, while also sharing the risks and benefits of the venture with the investor. Through the application of zakat, Islamic finance additionally encourages financial inclusivity. Muslims must give a percentage of their wealth to those in need as part of the Islamic practice of zakat. (Haron & Azmi, 2012)³³. Zakat is often collected and distributed by zakat institutions, which can help those who are underserved or excluded from traditional financial systems by offering them financial support. Islamic microfinance institutions (MFIs) have moreover become a significant source of financial services for the underprivileged and marginalized. Islamic MFIs offer a variety of financial services, including insurance, savings, and microcredit, and they run on the principles of Islamic finance. (Ahmed & Khan, 2012)³⁴. These organizations frequently target groups traditionally underserved by traditional financial institutions, such as rural areas, small enterprises, and women. Ultimately, Islamic banking has the potential to significantly contribute to the promotion of financial inclusion by giving underprivileged and marginalized people access to affordable and readily available financial services. Islamic finance is a natural fit for fostering financial inclusion since it is founded on the concepts of social justice and the equitable distribution of wealth.

3. Promoting entrepreneurship and investment

Islamic finance has the ability to contribute significantly to encouraging investment and entrepreneurship. This is so because Islamic finance is based on principles that encourage businesspeople and investors to engage in profitable economic activities that benefit society. These principles include

risk sharing, profit sharing, and ethical investing. (Hassan & Lewis, 2007). Musharakah is one of the major tenets of Islamic finance that encourages initiative and investment. A profit-and-loss sharing arrangement known as musharakah occurs when two or more parties invest money in a commercial enterprise and divide the profits and losses according to a previously decided ratio. (Ahmed & Khan, 2012)³⁵. By enabling individuals to combine their resources and expertise to launch a firm while also splitting the risks and profits, this model promotes investment and entrepreneurship. Mudarabah, another Islamic financial principle that was previously explored in the context of financial inclusion, encourages business ownership and investment. Mudarabah makes it possible for people to get finance even if they lack the resources or know-how to launch a business, while also sharing the risks and benefits of the venture with the investor. This strategy promotes investment and entrepreneurship by allowing people to start new businesses without having to take on significant debt. A further way that Islamic banking encourages ethical investing is by forbidding investments in sectors like alcohol, gambling, and cigarettes that are seen as being damaging to society. (Hassan & Lewis, 2007)³⁶. Instead, Islamic finance promotes investments in sectors like healthcare, education, and infrastructure that foster social and economic development. Overall, by offering creative financing options that encourage taking risks and investing in profitable economic activities, Islamic finance can significantly contribute to the promotion of entrepreneurship and investment. Islamic finance's guiding concepts of risk-sharing, profit-sharing, and ethical investing give businesspeople and investors a framework for actions that advance societal good and economic development.

Summary

Islamic finance has become a strong contender as a substitute for traditional finance since it provides a morally and socially responsible financial structure. The system is founded on Islamic principles, which include risk-sharing agreements, asset-based financing, and profit-and-loss sharing. By offering

financial services to disadvantaged groups in society, Islamic banking serves as a major force for socioeconomic development and the reduction of poverty. Islamic finance has a vital role in reducing poverty. It aids in financial inclusion and economic growth by giving people access to financing that they might not otherwise have had. The promotion of moral and just financial practices that make sure the rewards and risks of financial transactions are shared between the lender and the borrower is one of the main characteristics of Islamic finance. This is accomplished by utilizing financial services and products that adhere to Shariah and are intended to advance justice, fairness, and openness.

Islamic finance offers social financing packages that benefit society's most vulnerable and in need individuals. Zakat (charitable contributions), Waqf (endowments), and Qard al-Hasan are some of these goods (interest-free loans). Islamic banking encourages social cohesiveness and lowers poverty by giving aid to those in need. Islamic finance has the potential to make a significant contribution to sustainable development and the eradication of poverty. It supports the objective of ending poverty. To fully fulfill the promise of Islamic banking, there are still a few issues that must be resolved. The general public's and politicians' ignorance of and lack of knowledge of Islamic finance is one of the main issues. To promote Islamic finance and its potential to aid in the eradication of poverty and the advancement of sustainable development, more education and awareness-raising initiatives are required. In conclusion, Islamic financing plays a crucial role in reducing poverty. It provides a moral and socially conscious financial system that promotes financial inclusion and economic growth. Islamic finance fosters social cohesion and lowers poverty by offering social financing items to those in need. To promote Islamic finance and its potential to aid in the eradication of poverty and the advancement of sustainable development, however, more education and awareness-raising initiatives are required.

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