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Shabbir, Muhammad Salman, Kassim, Normalini Md, Faisal, Muhammad and Sabti, Yousif Mousa (2018) Poverty reduction through Islamic modes of finance; The way forward. Journal of Social Sciences Research, 4. pp. 58-65.

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The Journal of Social Sciences Research
ISSN(e): 2411-9458, ISSN(p): 2413-6670
Special Issue. 4, pp: 58-65, 2018
URL: https://arpgweb.com/journal/journal/7/special_issue
DOI: https://doi.org/10.32861/jssr.spi4.58.65

Academic Research Publishing Group

Original Research Open Access

Poverty Reduction through Islamic Modes of Finance; the Way Forward

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Abstract

The purpose of this paper is to share the conceptual overview of the role that Islamic modes of finance can play in the reduction of poverty. The underpinning principles of Islamic finance modes is the adherence of Islamic values and to promote economic and social justice in the society. This study is aimed at providing insights on the prevailing poverty reduction strategies and their respective impact on poverty eradicate alongside proposing an alternative Islamic model of poverty reduction. For this purpose, the present study overviews the existing literature and textual analysis of the subject to emphasize the significance of poverty as an issue around the globe along with the critical review of the strategies currently considered to eradicate poverty. Poverty has now been emerged as a global phenomenon, which is common across many nations and, perhaps, not surprisingly, a tough challenge to governments and community development-oriented organizations which have been striving to eradicate. The present paper is, therefore, an effort to propose a possible alternative approach for poverty reduction. Subsequently, some discussion has been made on the application of Islamic approaches of welfare and poverty reduction. Islam, as a religion, encourages healthy competition, private ownership, and allows demand and supply rule of working independently. Islamic approach to poverty reduction has multiple facets and it is aimed at reducing the gap between haves and have not's through optimum circulation of wealth in the economy and by restricting capital to generate capital and allowing other factors of production along with the risk of loss to play their due role. Keeping in view the prevailing models of poverty reduction and critical evaluation of these models, the study has proposed Islamic modes of finance as a workable plan to reduce poverty and spread social justice in the society.

Keywords: Poverty; Poverty reduction strategies; Islamic modes of finance.

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1. Introduction

In the last three decades, Islamic mode of financing and banking has emerged as a unique option of banking for both Muslims and Non-Muslims by providing an easy solution to the start-up capital challenge for small and medium enterprises (SMEs). Islamic banking is a system or activity which obeys Islamic laws and Shariah principles followed by the Islamic economics. Consequently, in the current business world, Islamic banking is known among investors and entrepreneurs for the following features: providing zero-interest credits, sharing of profit and loss, possessing of goods, participating in trading activities, leasing and construction agreements. Islamic banking, as a concept, has also gained worldwide popularity due to the significant opportunities it offers, such as the diversification of the investor base and its ability to attract and increase a country's investment. This phenomenon was especially evident during the global economic meltdown (2006-2009) when significantly higher compound annual growth rates were recorded in the Islamic banking industry as compared to the traditional banking. Also, the revival of Islamic Economic System is now correspondingly demanded by Muslims who are one-sixth of the world population (Memon, 2007) and projected to be around 2.6 billion, or over 26%, of the world population by 2050. This means that one out of every four people by the middle of the 21st century would be Muslim, aspiring to lead an economic life as envisaged by Islam.

Equal opportunity to earn income is basic human right. Making a living with lawful earnings is possible by working for others, becoming self-employed or employing others. The process of employing others is an entrepreneurial activity. A religion that has a valuable point of view about work and well-being is more likely to support the establishment of effective businesses and to help foster an entrepreneurial environment. Islam, as a religion, does not discourage working for others, but it inculcates and encourages a more entrepreneurial spirit (i.e.,

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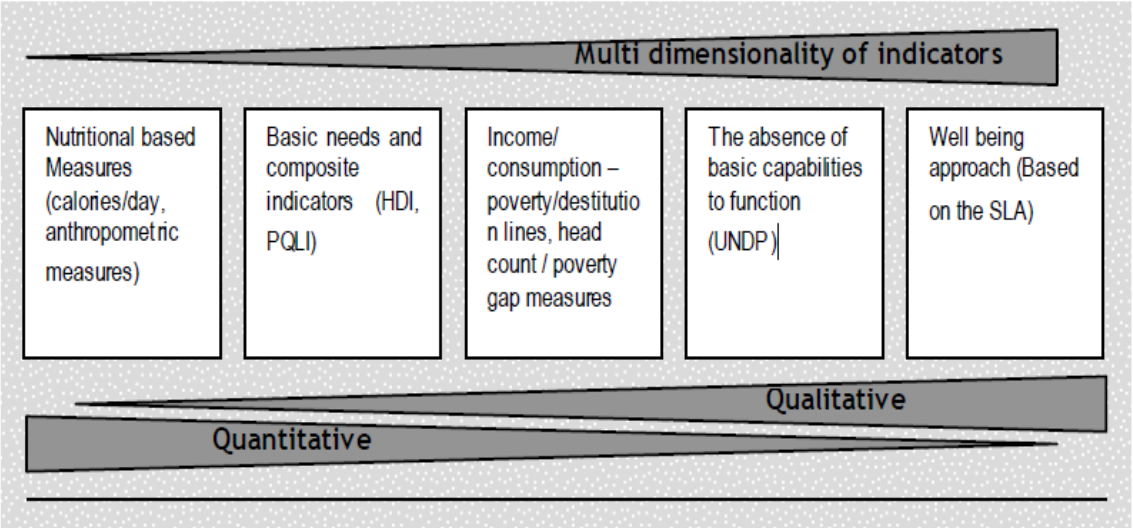
self-employment) to earn a living and help others who live under poverty (Hassan, 2013). The positive effect of this Islamic approach, to eradicate poverty would be tremendous if supported and encouraged, structurally through financial institutions and enforce by the government.

2. Poverty as a Concept

Poverty has been defined as a multidimensional construct in literature on development studies, as The World Bank (2010) divided poverty into two types; absolute poverty and moderate poverty. Absolute poverty describe as if a person earns less than $ 1.90 USD a day, the person should be categorized under absolute poverty, whereas moderate poverty refers to a person who earns $ 3.10 USD per day (The World Bank, 2010). Moreover, according to the UN declaration, poverty can be defined as: *"Denial of choices and opportunities, a violation of human dignity. It means lack of basic capacity to participate effectively in society. It means not having enough to feed and clothe a family, not having a school or clinic to go to; not having the land on which to grow one's food or a job to earn one's living, not having access to credit. It means insecurity, powerlessness and exclusion of individuals, households and communities. It means susceptibility to violence, and it often implies living on marginal or fragile environments, without access to clean water or sanitation". United Nations (2009)* Udaya (2008) explained poverty with the lenses of the dimensions of poverty as "*The economic well-being dimension, for example, captures the physical resources determining the material quality of life. […]. The capability dimension captures the ability, strength, or resourcefulness to produce the inner quality of life, enabling one to enjoy the freedom needed to achieve valuable functionings. […] The social inclusion dimension, moreover, embodies the resources needed to determine the social and relational quality of life with significant bearings on securing economic well-being and freedom* (Udaya, 2008).

As aforementioned, multidimensionality of poverty phenomenon, leads to a logical conclusion that poverty assessment would also needs to be diverse in order to grasp the deeper insights. Figure 1 indicates the multidimensionality of poverty as a concept in research literature.

Figure-1. Multidimensionality of Indicators to measure Poverty



Source: (Farrington and Gilling, 1998)

Farrington and Gilling (1998) further explained poverty in very holistic way in order to understand the concept. They further added that due to complexity of poverty, it is not advisable to understand it from dichotomous approach. Rather, they proposed that for better understanding of poverty, a blend of of qualitative and quantitative approaches should be adopted to examine the poverty and its various aspects of this phenomenon.

The rest of the paper is structured in various sections, the next section provides an insight about the global poverty reduction strategies, followed by a section highlights poverty reduction strategy powered by Islamic modes of financing. Succeeding section provides some implications of the current study along with some workable suggestions for governments and policy makers, while the last section concludes the paper.

2.1. Poverty Reduction Strategies

Millennium Development Goals Report (2009) were initiated by the United Nations to cope with challenges of the world by creating a global strategy and handholding. This is vital to mention that Millennium Development Goals (MDGs) are interrelated with one another, which considered as the most collective goal is poverty reduction. The goal of poverty eradication was further adopted by International Monetary Fund (IMF) and World Bank and by proposing Poverty Reduction Strategy Papers (PRSPs) across the globe (Narayan *et al.*, 2000). These Poverty Reduction Strategy Papers were prepared for less developed nations with the mission to grasp deeper insights on current state of poverty in these countries so that the remedial strategies to overcome poverty can be devised and proposed (Adejumobi, 2006). Adejumobi (2006) further highlighted and explained below mentioned important elements of Poverty Reduction Strategy Papers (PRSPs) that described the initiative;

- The country in which the Poverty Reduction Strategy Papers are initiated, should take lead in poverty reduction policy development and execution. The government should also be engaged with other stakeholders, this will help in greater commitment.
- The Poverty Reduction strategies and policies should be logical outcome and result oriented from initial analysis of poverty its causes and symptoms.
- The approach to Poverty Reduction should be ample and comprehensive which should include sectoral, cross sectoral aspects of property eradication.
- The policies aimed at Poverty Reduction should seek guidelines from sponsoring agencies, International bodies working for poverty reduction. This is imperative to align the vision of sponsoring agencies and international bodies with government.
- Poverty Reduction Strategy Papers (PRSPs) are for medium and long term that required commitment and ownership from all stakeholders in order to deliver the promised objectives.

Next section of the paper is regarding the importance and role of Islamic modes of financing and their respective role of the poverty reduction.

3. Islamic Model of Financing and its Impact of Poverty Reduction

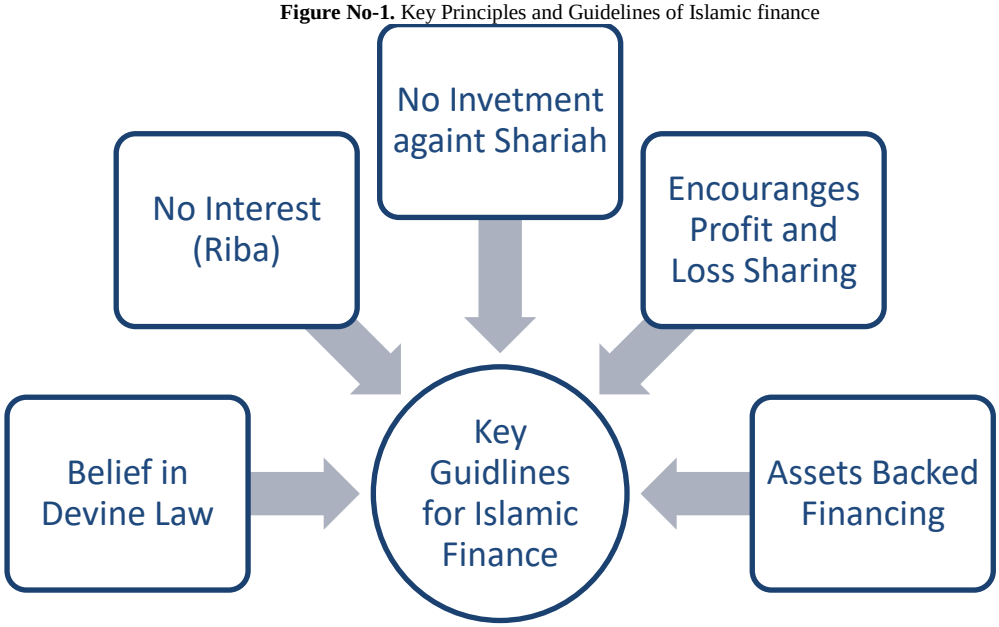
Islam presents itself as a complete code of conduct and proposes guidelines for social, political and economic issues of mankind. Obaidullah (2008) explained the comprehensive Islamic comprehension of poverty as, *"Islamic approach to poverty alleviation is more inclusive than the conventional one. It provides for the basic condition of sustainable and successful microfinance, blending wealth creation with empathy for the poorest of the poor…also…composite of mission-based and market based interventions…. favors equity-based and cooperation-based models in contrast to mechanism that create and perpetuate debt*" (Obaidullah, 2008).

A detailed comparison between Islamic modes of financing as compare to conventional banking indicates that both systems are common on the economic development objective, and on the social implications of the objective may leads towards promoting risk sharing, promoting entrepreneurship and involvement of less privileged section of the society in entrepreneurship activities Obaidullah (2008). Saad and Duasa (2010) proposed some of the key characteristics of Islamic microfinance as mentioned below

- Microfinance products and services could serve as basic guidelines to micro financial institutions in order to design Islamic microfinance services and products,
- Rational service charges,
- Easy and quick execution and evaluations of the applications
- Flexible terms of payments of arrears.

The modes of finance according to Islamic theology are different as compare to the conventional mode of finance, all modes of Islamic economic and financial institutions are bound to adhere the law of Holy Quran and guidelines derived from the Sunnah. The figure. 1 is reported by Abdullah D. V. and Chee (2010) identifying key principles and guidelines of Islamic finance. This guidelines play an imperative role for the policy making and design on the product and services offer by Islamic economic and financial institutions.

Figure No-1. Key Principles and Guidelines of Islamic finance



Source: Abdullah D. V. and Chee (2010)

The modes of finance according to Islamic theology are different as compare to the conventional mode of financing on some of the critical aspects (Obaidullah, 2008). These differences are shown in the below table No. 1.

Table No-1. Difference between conventional and Islamic finance

Category	Conventional Finance	Islamic Finance
Classification of poor	One category	Poor are classified at two levels. 1. Deeply Poor 2. Moderately poor
Bases of financing	Interest based	Profit and loss sharing and assets backed financing
Target of Empowerment	Poor and women	Poor and their respective families
Source of Funds	Savings of the customers, external funds and account holders	Savings of the customers, external funds and charity funds.
Dealing with default	Lobbying and pressure groups	Islamic ethics
Social Development Programs	Secular	Religious

Source: (Obaidullah, 2008)

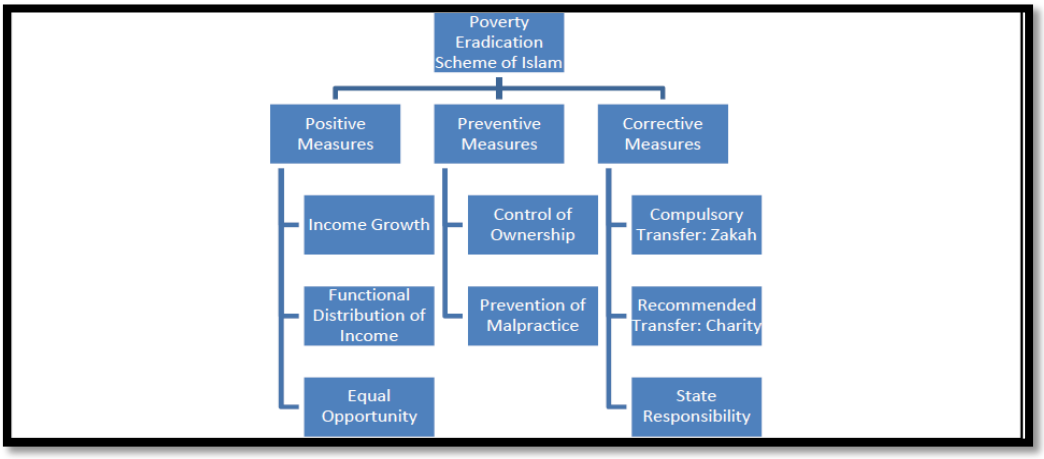
Hassan (2010) explained that Islam defined poverty on the bases of failure to gain access to five of the basic human needs, these are access to religion, wealth, physical self, dignity and knowledge. Moreover, Islam takes poverty as an indicator of social injustice in the society and place great emphasize on the eradication of poverty due to the fact that the impact of poverty is over welcoming and it creates divide in the privileged and less privileged segments of the society. This is also worth mentioning that poverty reduction approach in Islam is twofold, it involves government and privileged segments to take lead in the poverty reduction initiatives making this as a socio-religious issue. Islam condemns poverty as one of the great social evils. It is reported from The Prophet Muhammad ﷺ, that seek Allah's refuge from poverty.

"O Allah! I seek refuge with You from laziness and geriatric old age, from all kinds of sins and from being in debt; from the affliction of the Fire and from the punishment of the Fire and from the evil of the affliction of wealth; and I seek refuge with You from the affliction of poverty, and I seek refuge with You from the affliction of Al-Mesiah Ad-Dajjal. O Allah! Wash away my sins with the water of snow and hail, and cleanse my heart from all the sins as a white garment is cleansed from the filth, and let there be a long distance between me and my sins, as You made East and West far from each other." Hadith – SahihBukhari

Poverty is taken is one of the great economic problems in the world (Nofal, 1984), precarious social problem (Al Qaradawi, 2002), poverty cause many social issues and one of the oldest challenge of mankind (Iqbal, 2002), a paramount evil (Huq, 1996), and poverty can pose threat to stability and security of the society as well as to the human values and belief system (Salih, 1999). Poverty can disrupt stability of a country and human dignity can also be harmed (Fadhil, 1992). poverty is not only an economic issue but has social and political implications, which needs corrective measures to be installed (Alhabshi, 1993). Poverty impact on both individual and society on culture, thinking, belief system, believe and family (Al Qardhawi, 1980).

In the light and guidelines in the aforementioned saying of Prophet Muhammad ﷺ, the poverty cannot be reduced only by redistribution of income equally in all segments of the society. Sadeq (1997) and Hassan (2010) proposed an Islamic perspective on poverty reduction, poverty can be reduced by following a multi facet strategy. Poverty reduction measures were divided into three parts; positive measures, preventive measures, and corrective measures. Figure. 2 is elaborating the Islamic scheme of poverty reduction.

Figure No-2. Poverty Eradication Strategy of Islam



Source: Sadeq (1997) and Hassan (2010)

Generally, poverty is only measured and reported in the monetary and financial terms, but Islam has a very comprehensive understanding of poverty along with comprehensive implications of individual and society, additionally, poverty is a social issue as well (Hassan, 2010). According to The Prophet Muhammad ﷺ, poverty can lead to denial of almighty God, famously reported in the bellow in the Hadith in Sahih Bukhari; *"O Allah! I seek refuge with You from laziness and geriatric old age, from all kinds of sins and from being in debt; from the affliction of the Fire and from the punishment of the Fire and from the evil of the affliction of wealth; and I seek refuge with You from the affliction of poverty, and I seek refuge with You from the affliction of Al-Mesiah Ad-Dajjal. O Allah! Wash away my sins with the water of snow and hail, and cleanse my heart from all the sins as a white garment is cleansed from the filth, and let there be a long distance between me and my sins, as You made East and West far from each other."(Hadith – SahihBukhari).*

Moreover, the Holy Quran also emphasize the same notion as following manner. *"Alms are for the poor and the needy, and those employed to administer zakat (amil), for those whose hearts have been reconciled to the Truth, for those in bondage and in debt, in the cause of Allah and for the wayfarer" (9:60)*. In Surah Ba'qara, it is mentioned, *"O believers, whatever you have been given by God, spend from it" (2:254)*, followed by "*Those people who spend money in the way of God in a hidden or explicit manner will receiver great reward from their Creator." (2:247)*. It is also important to note that richness and poorness are perceived differently in Islam as compare to general understanding of these concepts, Hazrat Abu Hurairah (R.A) reported that the Prophet of Allah S.A.W said, *"Richness does not lie in the abundance of worldly goods but richness is the richness of the heart itself"* (Muslim, p. 501).

Hassan (2010) further proposed that Islamic approach of poverty alleviation involves comprehensive strategy on three folds, firstly to increase income of the poor people, secondly by encouraging the equal distribution of income and lastly, provide equal opportunities for all segments of the society. Islamic modes of financing and Islamic banking sector are one of the fastest growing sectors with double digit growth for three decades (Iqbal and Molyneux, 2005). Hassan (2010) suggested three types of Islamic modes or tools of funding and spending which are aimed at economic and social justice in the society, these are Zakat, Shadaqa and Waqf. Figure No. 3 presents the comparison of Zakat, Shadaqa and Waqf.

Figure No-3. Comparison of Poverty Reduction tools of Islam

	Zakat	Shadaqa	Waqf
Compulsory/ Voluntary	Compulsory	Voluntary	Voluntary
Rate	Fixed rate	Any amount	Any amount
Spend	Generally spent in one year	Generally spent in one year	Generally Capitalized
Investments	Generally not invested – needs to be discharged as soon as possible	Generally not invested – may be discharged according to need and mandate	Invested in social or economic asset
Time for payment	Generally paid in Ramadaan	Can be paid at any time	Can be paid at any time
How payment is made	Generally paid in cash or stocks	Can take the form of any asset	Can take the form of any asset – cash, land, coins, jewellery

Source: Hassan, Kabir, 2010

Zakat is an Arabic word with meaning to grow and increase (Qardhawi, 2009). The purpose of Zakat is to take a compulsory tax from the rich and disburse to the under privileged segment of the society to ensure that basic needs of the poor people are met. Zakat fund can also be created to make sure that funds are available to minimize the impact of zakat fluctuation (Chalikuzhi, 2009). Muslims are asked to pay 2.5% of the total saving every year and spend this money on the underprivileged segment of the society, Zakat is one of the source that ensure circulation of the wealth in any Muslim community that leads toward a health economic activity (Gambling and Karim, 1986; Hamid *et al.*, 1993; Lewis, 2001; Mohamed Ibrahim, 2001; Mohammed, 2007; White, 2004).

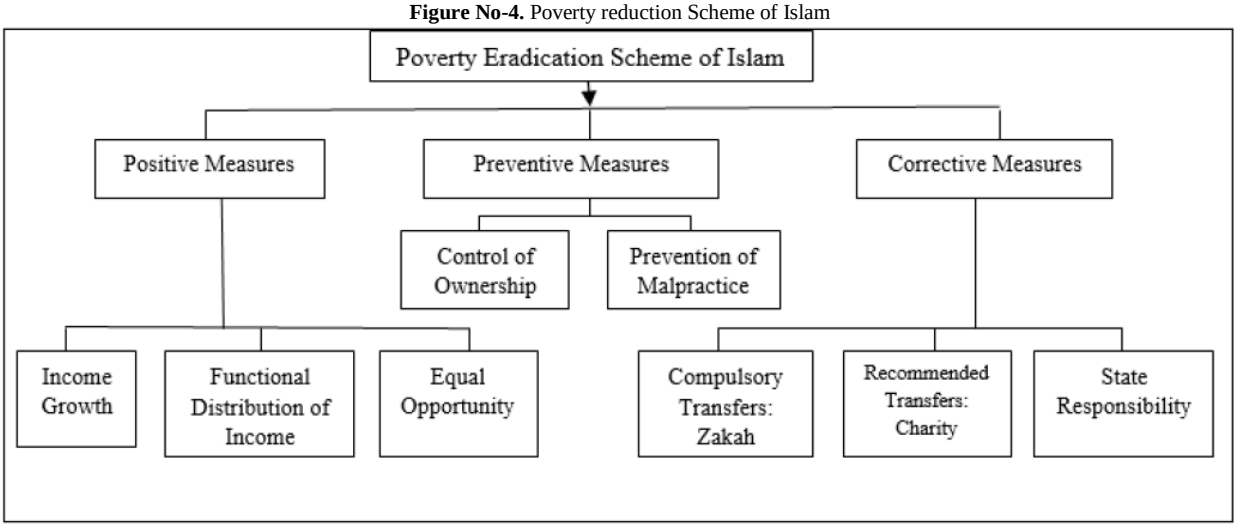
Shadaqa is taken from the Arabic root words of sidq, that means to give away goods and money in the name God by showing the faithfulness in almighty and expecting the reward of such spending in afterlife and resurrection (Qardhawi, 2009). Obaidullah (2008) proposed that there are various types of Shadaqa such as donations, gifts, charitable spending, and any gesture of kindness for the sake of God.

Waqf is derived from Arabic, which mean to preserve, stop and contain. In Islamic mythology, waqf means giving some physical assets or equipment for the betterment of the society in long term. Ahmed (2007) suggested that the waqf carried multiple purposes such as provision of any religious services, environmental, education, scientific and any other initiative of socio-economic nature.

According to Islamic approach to reduce poverty, there should be three types of measure which may be taken to address the issue of poverty. These are positive measures, preventive measures and corrective measures. Positives measures are the one which try to ensure equal distribution of wealth, equal opportunities of growth and positive sense of competition in the society. Preventive measures mean that concentration of wealth in few hands is

discouraged and unlimited of ownership is restricted to ensure the economic balance in the society. The corrective measure is aimed at anti-poverty programs such as compulsory payment of zakat, encouragement of charity, and the state is held responsible for the basic necessities of the country. Poverty reduction Scheme of Islam was proposed by Hassan and Khan (2007) keeping in view these three dimensions of poverty reduction. Please refer to Figure No. 4 for Poverty reduction Scheme of Islam.

Figure No-4. Poverty reduction Scheme of Islam



Source: (Hassan and Khan, 2007)

Even though the roots of Islamic Banking are in the Islamic economic system, it is not limited to Muslims only as Islam seeks the welfare of the whole humanity (Memon, 2007). Islamic banking refers to a system that follows Shariah principles of the Islamic law and works under the direction of Islamic economics. The major difference between Islamic banking and conventional banking is that latter is interest-based while the former is interest-free (Ariff, 1988). Therefore, Islam banking practices interest-free loan activities, low consumer-loaning and profit-and-loss sharing. Under the terms of Islamic profit-and-loss sharing, the connection between the borrower, investor and intermediary is rooted in financial trust and partnership (Yudistira, 2004). Generally, the role of Islamic banking institutions is to provide business financing products to individual entrepreneurs for their businesses (Abdullah N. *et al.*, 2016). The Islamic banking institutions provide financial products through their Shariah-based dealings which comprise of al- Wadiah, al-Mudharabah, al-Musharakah, al-Tawarruk, and al-Ijarah (Awang *et al.*, 2014).
The next section of the paper is about implications and future recommendations of the current study.

4. Implications and Recommendations of the Study

The primary purpose of the study was exploring the issue and its dynamics for better understanding and policy recommendations, after exploring through the existing literature on the phenomenon of poverty. Based on the above-mentioned literature, some of the recommendations are proposed in order to reduce poverty and enhanced social justice in the society.

1. The Islamic microfinance institutions are neglecting the very poor segment of the society. These are the major portion of the society causing greatly towards the increase in poverty.
2. Real implementation Islamic banking tight up with the federal bank rules and regulations. Generally, Islamic banking, especially personal loans or mortgage loans charging individual with high interest rate and penalty apply when individuals try to do early settlement.
3. Islamic banking concept by Syariah has been against while federal banks involve and implements their rules. Penalty has been enforced for early settlement, the rates are higher compare to conventional banking.
4. The poor segment of the society should be allowed to have an immediate access to finance for small business ventures, these small business ventures will boost the economic development of the nation and overall productivity of the country will be enhanced.
5. Islamic microfinance institutions should offer loans and business partnership schemes to enhance productivity and to reduce poverty.
6. Islamic microfinance institutions need to enhance the awareness of their loans and business partnership schemes to public so that maximum people can reap benefits from such initiatives.
7. Islamic microfinance institutions should ensure that speedy processing of all such loans should be ensured to save time and efforts.

The study also tried recommending for the future research in area of poverty reduction in order to develop an appropriate model and approach of Islamic modes of microfinance that can suite any nation.

5. Conclusion

This paper tried to make an attempt to understand and explore the poverty, poverty reduction strategies with special focus on the Islamic perspective of poverty, and poverty reduction. Thorough analysis of the literature has

been performed in order to determine the causes and possible solutions of the problem. To conclude, as discussed earlier that poverty is a multidimensional issue thus required and multi-faceted approach to handle the issue. The poverty reduction approach needs to be based on human capital development, availability of the resources to poor people, capacity building of poor people, creativity, enhancement of skills and ensuring that all poverty reduction initiatives are sustainable. Islamic modes of funding used for micro sector business can leads toward economic wellbeing and economic growth in less developed countries. This paper presents a conceptual review of Islamic social believes, point of view on inequality and possible solution for poverty reduction. Furthermore, the role of Islamic doctrine of financial and charitable options integrated with a comprehensive poverty reduction initiatives can be helpful for less developed countries. It is also proved in the history that if applied with proper protocols and controls Islamic modes of finance are capable enough to eliminate poverty, it was observed during the time of second successors of Prophet (S.A.W) Hazrat Umar bin Al-Khattab (R.A) and Umar bin Abdul Aziz (R.A), it is reported in the history that people were so prosper that it was difficult to find who can be given any type of charity.

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