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## **Empowering Micro Entrepreneurs through Islamic Finance: A Shariah-Based Model for Poverty Alleviation and Economic Inclusion in Pakistan**

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### **Abstract**

Poverty and financial exclusion remain persistent challenges in Pakistan, particularly among rural populations and marginalized groups. Conventional microfinance, though widespread, often fails to address the socio-religious sensitivities of a predominantly Muslim society due to its reliance on interest-based mechanisms. Islamic finance, grounded in the principles of justice, risk-sharing, and the prohibition of *riba* (interest), offers a viable and ethical alternative. This paper explores how Shariah-compliant financial instruments can empower micro-entrepreneurs and serve as a sustainable model for poverty alleviation and economic inclusion in Pakistan.

The study examines key Islamic financial tools such as *Qard Hasan* (benevolent loans), *Murabahah* (cost-plus financing), *Musharakah* (partnership), and *Waqf* (endowment), and evaluates their applicability to micro-entrepreneurship. Drawing upon successful case studies, including the Akhuwat Foundation and other local Islamic microfinance initiatives, the paper proposes a Shariah-based framework that integrates financial access with social development.

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This model emphasizes community participation, ethical governance, financial literacy, and integration with Islamic social finance instruments like *Zakat* and *Waqf*. The findings suggest that Islamic microfinance not only addresses capital needs but also upholds the dignity of the poor, promotes entrepreneurship, and aligns economic activity with moral and religious values.

The paper concludes by offering policy recommendations for regulatory support, public-private partnerships, and institutional capacity building to scale Islamic microfinance across Pakistan. It argues that empowering micro-entrepreneurs through Islamic finance is not just a financial solution, but a transformative strategy for inclusive and sustainable economic development.

**Keywords:** Islamic Microfinance, Poverty Alleviation, Economic Inclusion  
Shariah-Based Financing, Micro-Entrepreneurship in Pakistan

## Introduction

Pakistan faces widespread poverty, with over 20% of the population living below the poverty line. Most of the poor are excluded from the formal financial system, especially women, youth, and rural entrepreneurs. The need for ethical, sustainable, and inclusive financial systems is greater than ever.

Islamic finance, based on the principles of risk-sharing, ethical investment, and interest prohibition (*riba*), presents a culturally acceptable and morally responsible solution. Unlike conventional microfinance, Islamic microfinance aligns with the socio-religious values of the majority population and promotes fairness, justice, and shared prosperity.

## Islamic Finance and Its Socioeconomic Philosophy

Islamic finance is not merely a set of financial transactions free from interest; it is a **comprehensive economic system** rooted in the moral, ethical, and

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legal principles of Islam. Its ultimate objective goes beyond profit-making — it seeks to establish economic justice, social equity, and human dignity, aligned with the spiritual and material well-being of society. Grounded in the teachings of the **Qur'an and Sunnah**, Islamic finance aims to build a balanced and inclusive economic order that prevents exploitation and promotes collective prosperity.

### ***The Prohibition of Riba (Interest)***

At the heart of Islamic finance is the categorical prohibition of *riba* (interest), which is seen as exploitative and unjust. The Qur'an declares:

***“Allah has permitted trade and forbidden riba.”<sup>1</sup>***

Riba-based systems favor capital owners at the expense of borrowers, often leading to wealth concentration, debt cycles, and social inequality. In contrast, Islamic finance promotes **trade, investment, and partnership**, ensuring that risks and rewards are shared equitably between parties.

### ***Risk Sharing and Partnership***

Islamic finance promotes risk-sharing mechanisms such as:

- **Musharakah (joint venture):** Both parties contribute capital and share profits and losses.
- **Mudarabah (trust-based investment):** One party provides capital while the other manages the business.

These models foster entrepreneurship and trust, making the financier a partner, not a creditor, and encouraging productive economic activity.

### ***Asset-Backed and Real Economic Activity***

Transactions in Islamic finance must be backed by tangible assets or

services. This ensures that money is used as a **medium of exchange** and not a commodity for speculation. This principle avoids economic bubbles and promotes stability.<sup>2</sup>

### ***Prohibition of Gharar (Excessive Uncertainty) and Maysir (Gambling)***

Islamic financial contracts must be free from undue ambiguity (*gharar*) and gambling (*maysir*), both of which create uncertainty, exploitation, and injustice. This promotes transparency, clarity, and mutual consent in contracts, protecting both buyers and sellers.<sup>3</sup>

### ***Wealth Circulation and Social Justice***

One of the key objectives of Islamic economics is to ensure fair distribution of wealth and prevent its hoarding:

***“So that wealth does not circulate only among the rich among you.”<sup>4</sup>***

This is achieved through instruments like:

- **Zakat:** Mandatory almsgiving to purify wealth and support the needy.
- **Sadaqah:** Voluntary charity.
- **Waqf:** Perpetual endowments for public welfare (education, healthcare, etc.)

These tools form the social finance pillars of Islam, ensuring that financial systems serve the community and not just individuals.

### ***Ethical Investment and Halal Economy***

Islamic finance prohibits investment in sectors that are harmful or unethical, such as: Alcohol, Gambling, Weapons, Pornography and Interest-based institutions.

This promotes a halal and wholesome economy, encouraging investment in agriculture, SMEs, education, healthcare, and sustainable development.

### ***Accountability and Moral Responsibility***

Islamic finance is based on trust (amānah) and accountability (mas'ūliyyah). Every financial activity is subject to divine accountability:

***“Then you will surely be asked that Day about the pleasures  
[you enjoyed].”<sup>5</sup>***

Muslims are accountable not just to legal authorities but to Allah for how they earn, spend, and invest their wealth. This instills ethical behavior and discourages corruption and greed.

The socioeconomic philosophy of Islamic finance presents a holistic and values-driven approach to economic life. It encourages productive enterprise, financial inclusion, poverty alleviation, and social welfare, while discouraging exploitation, materialism, and inequality. In countries like Pakistan, where economic disparity and poverty are widespread, Islamic finance offers a just and practical model for sustainable development, entrepreneurship, and communal upliftment — all while remaining faithful to Islamic teachings and spiritual principles.

### **Challenges Faced by Micro-Entrepreneurs in Pakistan**

Micro-entrepreneurs play a critical role in Pakistan's economy, especially in generating employment, supporting household incomes, and contributing to grassroots development.<sup>6</sup>

However, they face numerous structural, financial, and social barriers that hinder their growth and sustainability. These challenges are particularly severe for women, youth, and rural business owners, who remain among the most economically vulnerable groups.

### ***Limited Access to Capital***

One of the most pressing issues micro-entrepreneurs face is the lack of access to affordable and Shariah-compliant financing. Conventional financial institutions often require:

- High-interest rates (riba), which are religiously unacceptable to many Muslims.<sup>7</sup>
- Collateral and credit history, which most micro-entrepreneurs lack.
- Complex paperwork and procedures, which discourage illiterate or semi-literate applicants.

This financial exclusion pushes many toward informal moneylenders or halts business growth altogether.

### ***Lack of Financial Literacy and Business Skills***

Most micro-entrepreneurs in Pakistan operate informally and have little to no training in essential business skills such as basic accounting, record-keeping, market research, pricing strategies, digital literacy, and financial planning. Additionally, they often lack awareness of their financial rights and responsibilities.

This knowledge gap results in inefficient use of resources, reduced profitability, and heightened vulnerability to exploitation. A major barrier to growth is inadequate market access—particularly in rural and peri-urban areas—where small business owners struggle to reach broader markets, compete with large-scale commercial suppliers, and navigate complex supply chains and logistics. These limitations lead to low sales volumes, limited business expansion, and unfair profit margins.

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Women micro-entrepreneurs face even greater challenges due to gender-based and social constraints. Cultural norms often restrict their mobility and public engagement, while their lack of asset ownership, limited access to digital tools or bank accounts, and systemic gender discrimination in credit and training programs significantly hinder their economic empowerment and discourage participation in entrepreneurial ventures<sup>8</sup>.

Furthermore, regulatory and legal hurdles present another layer of difficulty. Many micro-enterprises remain unregistered due to complex bureaucratic processes, limited knowledge of tax and labor laws, and fear of government oversight. Consequently, they are excluded from public funding, subsidies, and formal legal protections.

Infrastructural deficiencies such as electricity shortages, lack of clean water, poor internet connectivity, and inadequate roads—especially in rural Pakistan—pose significant operational challenges that reduce efficiency in production and delivery.<sup>9</sup>

Moreover, the absence of strong institutional support means that many micro-entrepreneurs have limited or no access to incubation centers, mentorship opportunities, or business development services, thereby stifling innovation and long-term business sustainability.

Micro-entrepreneurs in Pakistan face a web of interconnected challenges that stem from financial, educational, legal, and social constraints. Overcoming these barriers requires an integrated approach that includes **Islamic financial alternatives**, capacity-building programs, gender-sensitive policies, and inclusive infrastructure development. Only by addressing these issues holistically can micro-entrepreneurs thrive and contribute meaningfully to Pakistan's economic growth and poverty reduction.

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Here is your content refined into **well-organized paragraph form** for improved readability and academic presentation under the heading:

### **Shariah-Based Financial Instruments for Micro-Entrepreneurship**

Islamic finance offers a wide array of financial instruments that are ethically grounded, interest-free, and aligned with the principles of social justice, inclusion, and economic empowerment.<sup>10</sup>

These tools are particularly valuable for micro-entrepreneurs in Pakistan—many of whom are excluded from the conventional financial system due to lack of collateral, religious concerns regarding interest-based borrowing, or limited financial literacy. Shariah-compliant financial instruments provide accessible and sustainable alternatives that promote entrepreneurship, fair risk-sharing, and poverty alleviation while reinforcing trust and moral responsibility.

One of the most effective tools is **Qard Hasan**, an interest-free loan provided for welfare purposes or to help individuals initiate or expand small businesses. It carries no profit or financial burden and fosters social solidarity within communities.

This model is ideal for the ultra-poor or those lacking collateral or formal credit history. The Akhuwat Foundation in Pakistan has applied this model successfully at scale. Another commonly used instrument is Murabahah, or cost-plus financing, in which a financier purchases an asset and sells it to the client at a disclosed markup. Repayments can be deferred or made in installments, and the asset must be tangible. Murabahah is often used to finance equipment, livestock, raw materials, or other goods required by micro-entrepreneurs.

Musharakah, or equity partnership, allows both the entrepreneur and the financier to contribute capital and share profits based on a pre-agreed ratio while losses are shared according to capital contribution.<sup>11</sup>



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It builds mutual trust and is suitable for cooperative businesses, agricultural ventures, or family-run enterprises. Similarly, Mudarabah involves a contract where one party (rabb al-māl) provides capital and the other (mudarib) offers managerial expertise. Profits are shared based on mutual agreement, while losses are borne solely by the investor, unless caused by mismanagement or negligence. This structure is well-suited for skilled, capital-deficient entrepreneurs such as tailors, artisans, and service providers.

**Ijarah**, or Islamic leasing, is another Shariah-compliant tool in which an asset is leased by the financier to the entrepreneur for a fixed rental fee.<sup>12</sup>

Ownership may eventually transfer to the entrepreneur through an Ijarah wa Iqtina arrangement. This model is ideal for providing access to machinery, transport vehicles, shops, or farming tools. Finally, Waqf-based microfinance involves the use of Islamic endowments, where proceeds from donated assets are used to fund social programs. Waqf funds are perpetual and non-reversible, and can be effectively used to support Qard Hasan, business training, and incubation programs. This model supports community-owned revolving funds and targets vulnerable groups such as women and youth.

Shariah-based financial instruments offer a flexible, ethical, and socially responsible approach to empowering micro-entrepreneurs in Pakistan. These tools not only provide financial capital but also foster values of equity, cooperation, and accountability. When integrated into mainstream microfinance models and supported by community and institutional mechanisms, Islamic financial instruments have the potential to create an inclusive financial ecosystem that uplifts Pakistan's economically marginalized while remaining true to the country's religious and cultural foundations.

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## A Proposed Islamic Microfinance Model for Pakistan

To address poverty, financial exclusion, and lack of entrepreneurial support among the underprivileged in Pakistan, there is a pressing need for an Islamic microfinance model that aligns with the values and socioeconomic realities of the country.<sup>13</sup>

The proposed model combines Shariah-compliant financial instruments **with** social welfare mechanisms, institutional support, and community participation. It emphasizes dignity, risk-sharing, and equitable growth — all deeply rooted in Islamic economic philosophy.

Microfinance model is designed to target micro-entrepreneurs in Pakistan who have low or no access to formal financial services.<sup>14</sup>

These include women and youth in rural and semi-urban areas, informal sector workers, home-based business owners, and zakat-eligible individuals striving for sustainable livelihoods. At the heart of this model are Shariah-compliant financial products tailored to the diverse needs of clients. These include Qard Hasan for the ultra-poor, Murabahah for purchasing assets or inventory with a disclosed markup, Musharakah and Mudarabah for partnership-based ventures, Ijarah for leasing machinery or workspaces, and Waqf-based funds to support charitable and interest-free lending. All these instruments adhere to Islamic legal principles that ensure transparency, prohibit riba (interest) and gharar (excessive uncertainty), and promote equitable risk-sharing.

The integration of Islamic social finance tools such as Zakat, Waqf, and Sadaqah strengthens the model's sustainability.<sup>15</sup>

Zakat funds can be used to support Qard Hasan schemes for the most vulnerable, while Waqf can help establish revolving funds to sustain micro-lending. Sadaqah can support business training and development services,

fostering long-term self-reliance.<sup>16</sup>

To enhance effectiveness, the model incorporates **capacity building** by offering training in entrepreneurship, business planning, financial literacy, and Shariah-based financial ethics. It also facilitates access to mentorship, markets, and digital tools, empowering clients not just financially but also intellectually and spiritually.

A community-based financing approach is vital to this framework. It includes the creation of local Shariah advisory boards for oversight, the establishment of microfinance support groups to reduce default risks, and the use of social collateral instead of physical assets, making services more accessible. Digital and mobile integration further enhances reach and efficiency.

Mobile banking and fintech platforms can deliver Shariah-compliant services across remote regions, while dedicated Islamic finance apps can support applications, tracking, and client reminders.<sup>17</sup>

Institutional and regulatory support is also crucial. Microfinance providers should be registered as non-interest-based institutions under SECP or SBP guidelines.<sup>18</sup> Collaborations with Islamic banks, NGOs, madāris, and community mosques can help extend outreach and maintain operational integrity. Regular Shariah audits and performance evaluations are necessary to ensure compliance and build trust.

The model follows a phased implementation strategy. In Phase 1, pilot programs should be launched in 2–3 districts with high poverty rates and strong Islamic financial awareness. Phase 2 involves scaling through government and donor support, while Phase 3 focuses on institutionalization via connections with national Zakat and Waqf boards. This phased approach ensures gradual learning, risk mitigation, and long-term integration.

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Expected outcomes of the model include increased access to ethical finance for low-income entrepreneurs, strengthened grassroots entrepreneurship, and poverty reduction through sustainable income generation. It will also foster greater trust in Islamic financial systems and promote financial inclusion aligned with religious and cultural values.

### **Policy Recommendations**

To operationalize this model, several policy recommendations are essential. These include creating comprehensive legal frameworks for Islamic microfinance institutions (IMFIs) under SBP and SECP, simplifying licensing processes, and ensuring Shariah standards are consistently applied through formal boards. Integration of Zakat and Waqf can be enhanced by developing national databases for collection and disbursement, mandating a portion of zakat for micro-enterprise development, and launching waqf-based revolving funds. Furthermore, financial literacy initiatives should be tailored to women, youth, and rural populations, with partnerships established between educational institutions and religious centers to promote Islamic economic principles. Materials should be made available in regional languages for greater accessibility.

Digitalization must be a cornerstone, with support for fintech innovations such as mobile-based, Shariah-compliant lending platforms, Islamic finance apps, and SMS-based micro-loan services. These should be integrated with **NADRA** and Ehsaas databases for verification and alignment with social safety nets. Lastly, public-private partnerships (PPPs) should be fostered between government agencies, Islamic financial institutions, NGOs, madāris, and civil society to ensure broad-based implementation. CSR contributions should be encouraged, and joint training or research centers should be established to build capacity in Islamic

microfinance.

In conclusion, this proposed Islamic microfinance model is not merely a financial mechanism but a **comprehensive empowerment strategy** that unites Islamic values with economic justice. It addresses both the **material and moral dimensions** of poverty and provides a dignified, ethical, and sustainable path to economic inclusion for millions of underserved and marginalized citizens of Pakistan.

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