The Challenge of Poverty and Mapping out Solutions: Requisite Paradigm Shift from a Problem-Solving and Islamic Perspective

Dr. Mohammad Omar Farooq

Abstract

Islamic economics [IE] emerged with a new vision and aspiration of a better path to development. Unfortunately, IE has evolved mostly as an intellectual/academic shell, in which poverty eradication, except in rhetoric, is a peripheral concern.

Gradually, IE was eclipsed by its offshoot, Islamic finance [IF], which evolved as a prohibition-driven, legalistically-shaped, “shariah-compliant” industry, but delinked from the broader development aspirations. Encouragingly, renewed soul-searching is causing a shift toward substantively dealing with the challenge of poverty. However, beyond the issue of type of enterprises, policy frameworks and tools/mechanisms, a paradigmatic shift in IE/IF’s focus is needed. This paper argues that a few key aspects must be addressed at a more fundamental level, without which mere institutional/legalistic changes in the financial/monetary sector, as opposed to the real sector, may prove inadequate for development and poverty alleviation. This paper explores some of those key aspects relevant to a needed paradigmatic shift, especially from a problem-solving perspective.

Introduction

Poverty is probably the most serious, pervasive, and persistent problem affecting much of the world population, of which the Muslim world is a sizeable part.

Beginning in the early 70s, Islamic finance has come a long way. It has experienced phenomenal growth over the last three decades, spreading all over the Muslim world and countries with significant Muslim population. It has also been welcomed by the mainstreet, i.e., the Wall Street. Receiving increasing and aggressive patronization of the global powerhouses of the conventional finance, it has unquestionably shattered all skepticism about its viability. It is viable like any other conventional financial institution, and it is here to stay.

However, when the adjective ‘Islamic’ is added to finance, the implication is more than just being viable or even “shariah-compliant”. In this regard, there are some fair

1 Royal University for Women, Bahrain, faroqm59@yahoo.com, phone- 973-3933-5793
and some unfair criticisms of Islamic finance as it has evolved. One fair criticism of currentIslamic finance is that it is delinked from the broader goals or underlying intents (maqasid) of Islam. Thus, it is not connecting to and as such not having any impact on the real economic challenges, such as economic development in general and poverty, destitution, inequalities, etc., in particular. This criticism is valid because when the label “Islamic” is added to something, it comes under the full scope of the maqasid of Islam and then merely complying with some specific prohibitions is not sufficient consideration for something being Islamic. Another word, just like a Muslim can’t simply adhere to the prohibitions but not uphold the positive injunctions, such as praying, fasting, giving zakah, etc., and yet claim to be “Islamic”, the same is true about Islamic finance. Islamic finance evolved as part of a modern Islamic revival that sought a fundamental and comprehensive change in the spectrum of life. Thus, “Islamic” finance means more than just compliance with the prohibition aspects. This is a criticism that the industry has brought upon itself by hoisting the “Islamic” label, where it is neither ready to nor it might be possible to meet the currently held comprehensive expectations against which Islamic finance is evaluated. Let me defer the unfair criticism part for later in this paper.

Problem-solving perspective

The essence of problem-solving centers around a problem and it requires a resolute, focused and creative mindset that deals with the problem at the appropriate level. There is no single, cookie-cutter approach to problem solving, as it depends on the nature of the problem and the people and other factors involved. However, generally any problem-solving approach shares common components, such as: (a) clarifying description of the problem, (b) analyzing causes, (c) identifying alternatives, (d) assessing each alternative, (e) choosing the best or optimal one, (f) implementing it, and (g) evaluating whether the problem was solved or not. [McNamara, 2008]

The relationship between problem and solution should be conceptually simple enough to understand. Unfortunately, mere understanding of that relationship does not lend itself or amounts to a problem-solving approach. To elucidate, let us consider each of the components of problem-solving methodology in the context of poverty.

The first two steps in problem-solving methodology are to define the problem, and to analyze the causes. The steps constitute what can be described as the diagnostic phase. We know the importance of diagnosing a problem before a solution can be sought, identified, or implemented. The proponents of Islamic economics and finance

---

2 When referring to the maqasid, this author prefers using maqasid al-Islam, instead of maqasid al-shari'ah. This preference is due to serious confusion about the term shari'ah, which is explicated in detail in the chapter “Shari'ah, Laws and Islam: Legalism vs. Value-orientation” in Farooq, 2009a.
generally critique the western, conventional thoughts and practices as unislamic and advocate the Islamic mode based on several rationales, including the supposed positive effect of Islamic modes on development in general and poverty alleviation in particular. Yet, they seem to gloss over this phase in the context of poverty challenge. In reality there is a fundamental problem with our diagnosis.

In understanding the problem by defining it and identifying the causes, we have two choices. First is the repertoire of conventional thought in development as evolved through the western experience, and seen through the western lens. For examples, pivotal works in the field of modern economics, such as Adam Smith’s *An Inquiry into the Nature and Causes of the Wealth of Nation* [1976], or in the field of development Nobel Laureate Gunnar Myrdal’s *Asian Drama: An Inquiry into the Poverty of Nations* [1968], are relevant. The second or alternative choice would be independent contribution to thoughts about economic development in general and poverty alleviation in particular, from an Islamic perspective.

The unfortunate reality is that, whether taking the cue from the western experience and discourse about development and poverty or contributing independent thoughts from Islamic perspective, there is a serious void. As far as any comparable independent contribution in the field of economics in general and development in particular, there isn’t any. The last Islamic personality whose relevant contribution enriched not just the Muslim world but also the repertoire of the entire humanity’s thought was Ibn Khaldun. For all practical purposes Ibn Khaldun was ignored or even disinherited by Muslims. The West discovered him, benefited from him and even acknowledged him for his pioneering contribution to sociology and the science of history. Muslims clung further to the legal traditions, amplifying the central place of law and neglecting almost all other discourses pertinent to the modern times.

It is only in the twentieth century Muslims began taking stock of their situation, and relevant programs, such as *Islamization of Knowledge*, are being undertaken. However, even within that context there are more philosophical, ideological, conceptual and polemical treatises than works reflecting efforts to understand the real-world problems and developing systematic empirical understanding. Let alone producing from their own Islamic perspective substantive or pivotal works like that of Ibn Khaldun in Islamic tradition or of Adam Smith, Gunnar Myrdal, etc. in western tradition, Islamic economists or social scientists did not fundamentally benefit from the Western discourse and experience in even investigating their own societies and developing closer understanding based on an empirical foundation.

Why does poverty persist? What causes poverty and accentuates inequality? Unfortunately, beyond blaming the western colonial hegemony or calling for prohibition of *riba* (generally understood as interest) and implementation of *zakah*, Muslims don’t have an explanation of the problem of poverty and underdevelopment.
As Mohammad Nejatullah Siddiqi, one of the pioneering elders among the Islamic economists, acknowledges and laments: “Consider the current focus of Islamic economists on Islamic finance and dearth of Islamic economic literature on poverty removal, inequality and development.” [Siddiqi, 2008]

With no explanation, theoretical and empirical, of our own as well as repudiation of the conventional economics of the western origin, it is no surprise that the anti-poverty rhetoric interspersed through the polemics of Islamic economics and finance has remained just that: rhetoric and polemics, with no dent made to the poverty in the real world. Most contemporary works on poverty and development from Islamic viewpoint cover the next three components of a problem-solving approach: (c) identifying alternatives, (d) assessing each alternative, and (e) choosing the best or optimal one. However, with a fundamental void in the first two components, it lacks the necessary foundation to build any solid, systematic and comprehensive plan of action. While there are now scattered microcredit programs as part of the poverty-alleviation efforts of the Islamic finance industry, without the plan of action being systematic and comprehensive, the sixth component - implementing it - inadequate and the seventh and the final component - evaluating whether the problem was solved or not – are still elusive.

Does this mean that the Islamic finance industry has no problem-solving perspective? The answer is, the industry does have a problem-solving perspective. However, the problem it is trying to solve or address is not poverty or underdevelopment. Rather, it is how to provide financial services and products similar to what the modern, conventional finance offers, but do so in a “Shariah-compliant” manner. If the issue of substance can be ignored, the industry is definitely a success in solving that problem. It already has an array of products for both consumer and business clients that are comparable to the array of the conventional finance, while this array is interest-free, as defined or claimed from the traditional perspective.

However, Islamic finance industry cannot be expected to be a serious solution provider to poverty and underdevelopment for two important reasons. First, fostering development or alleviating poverty is not the goal it is trying to accomplish and the problems pertaining to that goal this industry is trying to solve. Thus, whatever program it has for poverty alleviation is marginal or peripheral and also, without development or poverty being its focus, any impact on development or poverty would predictably be limited and incidental. Second, Islamic finance by itself should not be expected to alleviate poverty, because poverty – going back to understanding the nature and causes of the problem (the first two components of a problem-solving approach) – is not primarily an issue of finance. Indeed, recognizing that development is more than just economics or finance is vital. Thus, for successful poverty reduction strategies or solutions, as Kabeer observes: “...the challenge for the future...lies in the field of politics as much as in the domain of policy...in creating the capacity of
poorer and more vulnerable sections of society to influence those that make policies. .and hold them accountable.” [Kabeer, 2004:41]

As Ruby Payne has made the case in her highly acclaimed work *A Framework for Understanding Poverty*, escaping the poverty trap is dependent upon multiple interrelated factors, of which financial aspect is only a part. [Payne, 2005:7-8] Nowhere in the world commercial financial institutions are viewed or charged with the task or responsibility of solving the problem of poverty or underdevelopment. To expect the current Islamic financial institutions (IFIs) to do differently is untenable as the IFIs are set up to mirror conventional financing mechanism (even though, as the industry terms, in “Shariah-compliant” manner).

Problem-solving perspective in the context of poverty is to make it as the central to or focus of the effort, as part of a larger picture. If poverty alleviation or eradication is the priority, the bottom line from problem-solving perspective is that it must be treated as such, which is not the case right now in most poverty-ridden nations and societies. It is also not the case with the IFIs.

Since poverty is not merely an issue of finance it is important to understand its problem first, and place the problem in the proper context of broader development. Yet, since finance is an important component of the solution, the appropriate point of intervention for the financial component must also be identified. That’s where it becomes relevant to map out the solutions.

**Mapping out solutions**

Integral to the problem-solving approach is the assumption that solutions are generally not fortuitous. Of course, policies can’t be made for miracles or fortuitous outcomes. Rather, searching for solutions and instituting appropriate policy frameworks are relevant in the context of deliberate endeavors, where the connection or path from a problem to its solution has to be mapped out. Just like if one intends or desires to go from Los Angeles to New York or from New Delhi to Dhaka, the traveler must map out the route and not start from the origin in just any direction and then expect to end up at the desired destination by accident, it is the same for problem-solving approach. If something is proposed as a solution or goal, then the path between the problem and the solution or the origin and the goal/destination needs to be mapped out – a simple or common sense truth, but seems to be glossed over by so many.

It is important to remind ourselves that Islamic economics and finance critiques its conventional counterparts by claiming that either the conventional counterpart causes poverty or exploitation or that Islamic alternative can better handle (or even a must)
to remove poverty and exploitation. Islamic finance, drawing from the prohibition-driven premises, has been hailed for its positive effects. 

Islamic finance is more conducive to poverty alleviation. [Al-Jarhi, n.d.]

Islamic finance should be viewed as part of an evolutionary process in the deepening of the financial services industry, stimulation of real sectors in the economy and alleviation of poverty in the developing countries. [Husain, 2007]

Until very recently, with a growing interest of the Islamic finance industry in microfinance, the general reference to poverty and development in Islamic economics and finance literature has been mostly polemical, providing rationales for Islamic economics and finance. However, there has rarely been any mapped out solution showing the path between the problem and suggested solution. Generally, elimination of what is prohibited (such as interest, as part of the Riba-interest equation, see Farooq, 2009b) and instituting what is commanded (such as, and especially, zakah and awqaf) have been the primary emphases of the literature. Indeed, the Islamic finance developed and grew – rather rapidly – quite delinked from the broader objectives (maqasid) of Islam. Moreover, until recently, Islamic finance/banking industry avoided, shunned or even repudiated the Grameen Bank model as unislamic because it is based on interest.3

The case of Grameen Bank and its microfinance model are relevant because it is a mapped out solution to poverty. There is no unique solution, but it is mapped out in the sense that from the problem-solving perspective, poverty is the problem it is trying to solve and it has provided a mapped out solution and also implemented the solution with results that people can observe and verify against the claims of the microfinance industry in general for replicable results, and the Grameen Bank in particular, for its performance as a model institution.

Another example of mapped out solutions in this regard is Binary Economics, a little known framework pioneered by Louis Kelso, who developed the Employee Stock Ownership Program (ESOP) and later others, based on his ideas, further articulated Binary Economics.4 The goal of Binary Economics is to uphold a society’s absolute duty to ensure that all humans have access to basic needs, a share in the overall prosperity and an independent income. Because it believes that widespread iniquity and injustice exists even in the prosperous societies, it has attempted to identify the

---

3 Notably, it has been only in 2008 that a major Islamic financial forum has featured for the first time Nobel Laureate Muhammad Yunus as a keynote speaker. See Malikon, April 13, 2008. That Grameen Bank has long been viewed as unislamic, see Sait and Lim, 2005, p. 13. Also see Jolis, February 19, 1997.

causes and then provide specific, mapped out solution to achieve that goal. Interest-
free money creation and ensuring that everyone has a share in the growing capital
stock of the society, where the latter is to be facilitated by interest-free credit from the
central bank, are pivotal to its mapped out solutions. While its criticisms of the
conventional economics in a blanket manner are questionable and its theoretical
foundation is weak, especially in its attempt to present itself as a strand of economics,
but due to placing itself completely out of the entire legacy of economic thoughts in
history, some notable aspects of it deserve closer study. Just like there is not one
perfect and complete school of economic thought that obviates all other, I mention it
as an example of a mapped out solution, because despite its theoretical weaknesses, it
has clear and comprehensive ideas that show and explain how poverty and serious
economic inequities exist and there is a connection between its analysis of the
problem and the proposed solutions. In other words, right or wrong, it has a roadmap
toward the desired solution.

In contrast, let us consider Islamic banking and finance. The original rationale for
Islamic banking and finance has been that Islam prohibits *riba* and Muslims must
come up with Islamic alternative that is consistent with Islamic guidance and such
alternatives would help address the problems of poverty and economic inequities
much better. However, the reality is that, since poverty alleviation or eradication is
not the problem Islamic finance is trying to solve and thus quite understandably there
is no meaningful impact of the industry on poverty and deprivation, there is no
mapped out solution in this regard.

While this paper seeks to highlight and emphasize the importance of having a
problem-solving perspective and employing mapped out solutions, the scope of the
paper cannot accommodate the topic in depth. However, after elucidating those two
aspects – problem-solving and mapping out solutions – let us turn to the challenge of
poverty from an Islamic perspective.

**Approaching poverty as a development issue or for targeting specific segments**

Almost all the countries that achieved significant reduction of poverty have done so
as part of the overall economic development, due to which people benefited in
varying degrees. What is important is that development should occur in such a way
that the people have growing access to income-earning opportunities. In this
approach, poverty does not require separate or exclusive focus, as long as the
distributive benefits of development are widely shared. Many newly industrialized
countries have experienced rapid economic transformation to significantly enhance
the standard of living of their people in this manner. However, such development is
not merely due to economic and financial aspects, even though appropriate economic and financial policies as well as harnessing the relevant resources were indispensable.

In such approach to development a broad range of interrelated factors are involved. Obviously, in countries with widespread poverty, development needs to be handled in such a way so that how it reduces or eliminates poverty is appropriately mapped out, not leaving it to trickle down expectations. Much of the experience of growth-oriented approach to development has left “poverty traps” – bypassing the vulnerable and weaker sections of the society. [Dasgupta, 2003]

All the countries that have developed and successfully experienced economic transformation for the vast majority of their population had some common factors: (a) political stability [Berg-Schlosser and Siegler, 1990; Outreville, 1999; Siermann, 1998]; (b) good governance (political credibility, legitimacy and accountability) [Brunetti and Weder, 1994; Wohlmuth, et al., 1999; Lipset, 1959; Cracknell, 1989; Grindle, 2004; Rahman, 2006]; (c) rule of law [Higbee and Schmid, 2004; Haggard, et al., 2008; Ghani, undated]; (d) technology capacity building [Agarwal, 2006]; (e) policies to promote an enterprising culture and environment; (f) education [Ozturk, 2001; Schultz, 1992]; (g) provision of essential health services; (h) increasing participation of women, etc. These factors are widely discussed in the context of development and therefore there is neither any need nor the scope to deal with these in details here. However, as an example of placing these factors in an Islamic context, I will discuss one of these factors: good governance, of which political legitimacy is an important foundation. In explaining the theory of Ibn Khaldun, Umer Chapra identifies the lack of political legitimacy as the “primary cause of the decline” of the Muslim Ummah.

Six hundred years have passed since Ibn Khaldun wrote. The overall Muslim decline has continued persistently relative to major industrial countries even though it has not been a straight line phenomenon and some Muslim countries have done better than others. The primary reason for this overall decline is that political illegitimacy, which had triggered the decline, has continued until today in most Muslim countries. The Muslim world, which is much larger and diversified now than what it was in Ibn Khaldun’s times, has not been able until now to establish a procedure for the orderly transfer of the reins of power to the most upright and competent in the eyes of the people as desired by the Qur'an (49:13), the efficient and equitable use of public resources in accordance with the Shariah, and the free and fearless criticism of government policies. [Chapra, 2008:853]

How the issue of good governance (and the related matter of political legitimacy) is relevant should not require elaboration, especially in light of the contemporary experience in the Muslim World. Indeed, as this conference is being held in Dhaka,
Bangladesh, the matter of political legitimacy and good governance is probably most overriding for this nation, as it is also for most other Muslim-majority countries. Of course, all the above-mentioned factors for development, for example, technology capacity building, might not have special Islamic dimensions. Yet, these are factors that are universally present in all those countries that have experienced development, reduction or eradication of poverty and higher standard of living for their people.

Generally, a broad development approach that touches wider spectrum of the population has reduced the incidence of poverty, increased the standard of living and enhanced access to income opportunities. As part of mapping out solutions, such approach requires designing “poverty reduction strategies” (PRS) at the national level. [Green and Hulme, 875, citing Kabeer, 2004] Where development had a ‘pro-poor’ focus, the reward of development has been shared even more widely. [Ravallion, undated; Krauy, 2004; Kimenyi, 2006; Eastwood and Lipton, 2001; Son, 2004] “Pro-poor growth” may mean either of the two: “poverty falls more than it would have if all incomes had grown at the same rate” or that it simply “reduces poverty.” [Ravallion, undated] “Pro-poor” development involves policy regimes that deliberately seek out opportunities which, while helping an economy grow, allow more participation of the poor in the development process and sharing of its benefits.

If such development approach works, and it indeed has for countries within our own generational experience, why would other countries need a more targeted approach toward poverty alleviation, for example, through microfinance?

Notably, these are mostly non-economic or non-financial factors that are a must, without which financial institutions and their inputs or injections would not make the desired difference. Indeed, framing the poverty-related development discourse merely in financial or economic terms is a serious shortcoming, especially in understanding the nature of “chronic” or “persistent” poverty – “those individuals and households who experience poverty for extended periods of time or throughout their lives.” [Hulme, 2003: 399] Without such an understanding, which is often lacking in conventional, economics-dominated, development literature and fundamentally lacking in Islamic economics and finance, mapping out any effective solution would be next to impossible.

Current approaches to poverty in development studies have tended to highlight the precipitating causes of poverty at individual and household levels, while underplaying the social relations and categorizations which can contribute to long-term poverty. Recent work which attempts to theorize the persistence of poverty can provide a vehicle for the combination of qualitative and quantitative approaches to understanding poverty, allowing for the identification of intractable and persistent poverty and an entry point for further qualitative investigation and analysis. The concept of chronic
poverty, as characterized by duration, is particularly useful, not so much as a means of identifying the poorest, but for highlighting the outcomes of the entrenched social relations that work to produce the bundle of effects that make up chronic poverty. Chronic poverty offers the potential to move the analytical focus of research from correlates of poverty to causes of poverty. By viewing poverty in dynamic terms it helps reveal the social and political processes that make people poor and keep them in poverty. [Green and Hulme, 2005:868]

If the financing aspect, as for example Islamic finance, is not rooted in or relevantly based on Islamic economics, and Islamic economics is not duly rooted in the broader social disciplines, poverty alleviation programs might be narrowly focused on “money metrics” or income based notion of poverty. [Green and Hulme, 2005, 867; also Grosse, et al., 2008]

Conceptualizing deprivation in terms of chronic poverty, exploring the constraints that close off opportunities for upward social and economic mobility, and analyzing the politically entrenched social relations (household, community, national, and international) that work to produce the effects that constitute the experience of chronic poverty provides a potential means for deepening understanding and guiding action. [Green and Hulme, 2005:876]

Apart from the broad development approach that needs to be “pro-poor” there is room, need, and relevance for more targeted approach, especially where those who might be left behind by the broader development are effectively targeted. Both the “structurally poor” (those born into poverty) and the “incidental poor” (those fallen from better conditions) [Mattson, 2003] who are bypassed by the broader development would need targeted approach, especially through microfinance-type operations. Notably, from the Islamic viewpoint there is no consensus about the definition of poor. [Farooq, 2008]

**Poverty Alleviation and microfinance**

Microfinance type programs are highly acclaimed as effective in targeting specific segments of population in poverty and help ameliorate their economic conditions. The pioneering contribution of Muhammad Yunus and his Grameen Bank has been jointly recognized with the Nobel Peace Prize in 2006. Popularized through the Grameen Bank model of Yunus, microfinance became a movement attesting that access to credit is a fundamental human right. [Yunus, 1997; Robinson, 2001; Hudon, 2007]

Even though microfinance movement pioneered by the Grameen Bank has existed since the 1970s, around the same time when modern Islamic finance began finding its institutional shape, IFIs began waking up to the potential and relevance of
microfinance to Islamically approach poverty alleviation only recently. Islamic microfinance essentially takes the modern microcredit framework developed by Grameen Bank, but substitutes interest-based loans with “Shariah-compliant” modes, such as murabaha, buy muajjal, etc.

That IFIs are taking interest in microfinance to alleviate poverty is encouraging. As an example of mapped out solution to poverty alleviation, microfinance is especially relevant to IFIs. However, being a latecomer to microfinance the industry can significantly benefit from the accumulated experience, and avoid repeating some pertinent pitfalls, especially in the context of mapping out solutions. First, while microcredit institutions are widely acclaimed for their contribution to poverty alleviation, and in the earlier works on microcredit programs, such as Grameen Bank, were thought to be helping the “poorest of the poor,” [Wahid, 1994] there are now serious questions about whether they can reach and positively affect the “bottom poor.” [Develtere and Huybrechts, 2005] Using “a unique panel dataset with monthly consumption and income data for 229 households before they received loans” in two Bangladeshi villages, it is found “that while microcredit is successful at reaching the poor, it is less successful at reaching the vulnerable.” Their “… results also suggest that microcredit is unsuccessful at reaching the group most prone to destitution, the vulnerable poor.” [Amin, et al., 2001] In another study based on some programs in South Africa, it was found: “in practice, microfinance may still not reach the very poorest, since some borrowers still experience credit rationing in microcredit programmes, including inequality in terms of benefits and loan sizes as well as limited access to services.” [Hietalahti and Linden, 2006:202]

Second, empirical studies have shown that one time, one year credit has been less effective in helping the borrowers to rise above poverty sustainably than multiple time loans over a longer period of time.

In the Grameen Bank villages, for instance, 76 percent of participants who have taken no loans or only one loan are below the poverty line, compared with only 57 percent of those who have taken five or more loans. [Develtere and Huybrechts, 2005:169]

The data analysis suggests that it takes 9-10 years for an average Grameen Bank household to free itself from poverty by borrowing from and being a member of Grameen Bank. [Khandker, 1996:77]

As the empirical study of Chowdhury, et al, indicates:

The main objective of the micro-credit movement in Bangladesh (and elsewhere) is to reduce poverty. Bangladesh is a poor country with a relatively long history of micro-credit lending. Despite this there is still considerable debate in the development economics community concerning the effect of micro-credit on poverty. The analysis carried out in this paper
does suggest that micro-credit borrowing is associated with lower poverty. However, the effectiveness of micro-credit as a real poverty alleviation tool does not depend on its short-run impacts. Giving people money may raise them out of poverty for a short period of time but when the money is spent they fall back into poverty. For microcredit to permanently reduce poverty it must have a long-run impact. Micro-credit is not a short-run subsidy. Its aim is to lead to a sustainable increase in a household’s ability to create wealth. The analysis presented in this paper provides some evidence that the effect of micro-credit on poverty is particularly strong for about six years with some leveling off after that point. [Chowdhury, et al., 2005:306]

Third, microfinance, as for examples in case of Grameen Bank or Bangladesh Rural Advancement Committee (BRAC), is subsidized. “Analysis shows that Grameen Bank is heavily subsidized by donors and the government, thus, with its performance conditional upon grants and subsidized funds, Grameen Bank possibly cannot survive without subsidy.” [Khandker, 1996:66] Can microfinance programs be devised without subsidy? Some pioneering programs, such as Grameen Bank, have been successful in weaning itself from subsidy only after a long period of significant infusion of donor aids. Many NGOs in the microcredit industry survive primarily on such subsidies, and in reality many NGOs come to the industry specifically seeking such subsidies as avenues for financial benefits of the organizers of those NGOs.

The NGO sector is still, with exceptions, not financially sustainable and continues to rely on subsidies of various sorts. In these circumstances, there is a need for studies that shed light on the poverty consequences of different modalities. If NGOs are to continue to draw on subsidized finance there is a need to demonstrate that they can reach the poor and do so in a cost-effective manner, as compared with other forms of poverty targeting interventions. [Weiss and Montgomery, 2005:394]

In the long run, however, self-sustainability becomes critical. The subsidy aspect is relevant because Islamic microfinance is often proposed in the frameworks that involve subsidy components via zakah. [Ahmed, 2002; Dusuki, 2008; Abdul Rahman, 2007]

Third, despite the fact that Grameen bank-type microcredit institutions are highly acclaimed for their success in poverty alleviation, the reality of that success is murky and questionable, because hard data from such institutions is rarely publicly available for independent scrutiny and research.

The microfinance movement has captured the imagination of academics, policymakers, and practitioners. It has demonstrated possibilities for lending to poor households and has transformed discussions of poverty alleviation. However, few microfinance programs have received rigorous statistical
evaluations. Doing so is complicated by biases due to non-random program placement and participation by clients. Simple measures of impacts are thus likely to be driven partly by correlations of unobserved client quality and patterns of lending, with respect to both participation and the size of borrowings. [Morduch, 1998:30]

Fourth, there are studies that challenge the claims of spectacular success by microcredit institutions as overstated or dubious. For example, according to Morduch:

[H]ow great is the ultimate impact on poor households? While strong claims are made for the ability of microfinance to reduce poverty, only a handful of studies use sizeable samples and appropriate treatment/control frameworks to answer the question. … Simple estimates of impacts show clear achievements. For example, if households served by the Grameen Bank are ordered by the amounts they have borrowed from the program, the top quarter enjoys 15% higher consumption per capita than households in the bottom quarter. In addition, 62% of the school-age sons of Grameen Bank borrowers are enrolled in school versus 34% of the sons of eligible households that do not borrow. For daughters, the Grameen advantage is 55% versus 40%.

These simple comparisons appear to be driven entirely by selection biases, however. Once appropriate comparisons with control groups are made, access to the three microfinance programs does not yield meaningful increases in per capita consumption, the education of sons, nor the education of daughters. If anything, the levels are slightly lower than for control groups. The results are surprising and contradict frequent claims made about the programs in international discussions of microfinance. [Morduch, 1998:2]

Based on studying some key development indicators, the impact of microfinance is claimed to be lower than the usual claims. Matthieu Chemin’s study notes the following:

Using the latest developments from the evaluation literature, namely the technique of matching, … shows a positive, but lower than previously thought, effect of microfinance on expenditure per capita, supply of labour, and level of school enrolment for boys and girls. For instance, participants spend 3 per cent more on average than non-participants in control villages. [Chemin, 2008:465]

Even those whose empirical works attest to the generally positive impact of microcredit on the standard of living of the borrowers are not often able to attribute the effects to microcredit alone.
In summary we may conclude that borrowers are better off in terms of consumption of most of the food and non-food items compared to non-borrowers. These results suggest that microcredit programs are successful in bringing better consumption for borrowers. Our results further suggest that microcredit programs are doing well enough to bring better quality of life for borrowers by providing better consumption but we cannot say conclusively if there are other factors that may have impacted better consumption on borrowers apart from credit. [Rahman, et al., 2007]

Scores of other empirical studies have found the experience for different countries to be a “mixed bag.”

The empirical evidence on the impact of micro-credit on poverty, carried out for Bangladesh as well as for a number of other countries in Asia, Africa and Latin America is very mixed (see, for example, Hossain, 1988, Sebstad and Chen, 1996; Morduch, 1998, 1999; Edgecomb and Barton, 1998; Coleman, 1999; Schrieder and Sharma, 1999; see also Sharma and Buchenrieder, 2002, for an excellent survey of sixteen studies carried out for countries such as Ghana, Kenya, Malawi, Indonesia, Sri Lanka, Bolivia, etc.). Some impact/evaluation studies have found that access to credit by the poor has a large positive effect on living standards. However, other studies have found that poverty is not reduced through micro-credit – poor households simply become poorer through the additional burden of debt. [Chowdhury, et al., 2005:299]

In one of the most authoritative works on microfinance, the authors drew a rather harsh assessment of the rationale for allocating public resources toward microfinance.

MFI field operations have far surpassed the research capacity to analyze them, so excitement about the use of microfinance for poverty alleviation is not backed up with sound facts derived from rigorous research. Given the current state of knowledge, it is difficult to allocate confidently public resources to microfinance development. [Weiss and Montgomery, 2005:391, citing Zeller and Meyer, eds., 2002]

There are also serious accounting issues of institutions like Grameen Bank, which the critics allege mask the reality of the success with repayment or fund recovery rates. Apparently, the definition of a bad loan is too lax, allowing the repayment rate to be recorded as significantly higher than it is.

Grameen defines a loan as bad if it remains unpaid two years after its due date. Under those terms, 10% of all the loans are overdue. 19% of the loans are one year overdue and in Tangail in Bangladesh, 32.1% of the loans are two years overdue. The Consultative Group to Assist the Poorest from the World Bank recommends micro-lenders to report as ‘at risk’ loans with a
payment more than 90 days overdue and Accion requires this after 30 days. The Grameen Bank for obvious reasons does not publish the figures under those criteria. [Chemin, 2002]

Such accounting issues are important, because in the long run it becomes both a credibility and sustainability issue.

The experience of microcredit in two villages in Thailand, for example, illustrates the relevance of the institutions and the power structures affecting the distribution of benefit to the various borrowing groups. That study:

- evaluates the outreach and impact of two microfinance programs in Thailand, controlling for endogenous self-selection and program placement. Results indicate that the wealthier villagers are significantly more likely to participate than the poor. Moreover, the wealthiest often become program committee members and borrow substantially more than rank-and-file members. However, local information on creditworthiness is also used to select members. The programs positively affect household welfare for committee members, but impact is insignificant for rank-and-file members. Policy recommendations include vigilance in targeting the poor, publicly disseminating the program rules and purpose, and introducing and enforcing eligibility criteria. [Coleman, 2006:1612]

Fifth, there is wide diversion of microcredit funds due to fungibility. For example, “… many borrowers were using loans to purchase land, rather than to complete their proposed projects. Her anecdotal evidence is consistent with the evidence of relatively frequent and large land purchases here.” [Morduch, 1998:30, citing Todd, 1996] Fungibility is a well recognized and researched problem in the context of rural finance in general. [Khalily, M. 2004; Adams, et al., eds., 1984; Von Pischke, et al., eds., 1983]

- Failure to control for fungibility may over-estimate the impacts of microcredit intervention. This is particularly true when households have access to multiple sources of credit. [Khalily, 2004:336]

Sixth, the original microcredit movement started with a special anti-poverty zeal, which has given way to more commercial approach, as the pioneering organizations have grown into behemoths and bigger conventional financial institutions have smelt money in the poverty-pot. The experience of Rafael Llosa in Peru is relevant here. His success with the program he started now is under threat due to aggressive competition from larger commercial banks with deep pockets to lure away not just his clients with low rate loans, but also his experienced employees with better compensation. [Kiviat and Farooq, 2008]
Seventh, pioneering microfinance institutions, such as Grameen Bank, have been pioneers in another area: using their poverty alleviation to empower women by targeting female borrowers in particular. In societies where women in general are relatively more vulnerable and weak, this is definitely a positive development. However, some empirical studies, as for example in Guatemala, have shown that beyond certain stages, women borrowers are less aggressive in expanding their entrepreneurial efforts compared to the male borrowers. [Kevane and Bruce, 2001] To better map out solutions, there should be new research on whether targeting a family as a borrowing unit, where the husband and wife are joint borrowers, make any difference in this regard. Unfortunately, while IFIs has become a booming industry with hundreds of billions of dollars in assets and operations, the industry has no internal research infrastructure nor an interface with the external institutions to study the problems related to poverty and development.

Eighth, while microfinance is focused on poverty alleviation (trying to lift people out of poverty), most of these programs do not take into account the “poverty dynamics,” where “large numbers of people are escaping from poverty at any given time, but large numbers are also falling into poverty simultaneously.” [Krishna, 2007] As pointed out already, microfinance-based poverty alleviation programs are mostly targeting “whom” of poverty equation, generally neglecting the reasons of poverty.”

[T]he major focus so far has been whom to target and not so much on what to target, which is a mistake. When the objective of the aid effort is to reduce poverty sustainably, three steps need to be taken in order. First, actionable reasons for poverty must be identified. Second, programs must be devised that target these particular reasons. Third, efforts must be made to direct these programs toward the people who most need this support. The first and the second steps of this process have been mostly neglected so far—and the third and subsequent step has received the most attention. This paper is intended to help rectify this unfortunate imbalance.

Targeting reasons—for escaping poverty or for falling into poverty—must form a central part of the aid effort. … [T]argeting people is likely to be of little consequence unless reasons are simultaneously targeted through appropriate policy measures. [Krishna, 2007:1947]

Studies show that escaping poverty and falling into poverty are not symmetric in terms of reasons. Poor people escape from poverty as a result of one set of reasons, but people fall into poverty on account of a different set of reasons. Targeting both sets of reasons simultaneously is necessary; the growth of the problem will have to be contained even as the size of the problem is reduced. [Krishna, 2007:1952]
Households’ escape from poverty is assisted by one set of factors, but an entirely different set of factors is associated with households’ decline. Two distinct sets of policies are required thus, one set to promote escape from poverty and another set to arrest decline into poverty. [Krishna, 2004:127]

Most poverty alleviation programs do not benefit from the advances in knowledge and research in these areas of poverty dynamics. Also, it would not be an exaggeration to suggest that Islamic economics, finance and banking that is taking new and expanded interest in poverty alleviation, which is welcome, does not have any independent research to better understand the poverty dynamics. For example, one can search the publication database of Islamic Research and Training Institute of IDB, and out of 117 publications in English, there are only three (based on search with keyword “poverty”) that deal with poverty directly, and none of these three is based on real-world research about poverty. In those works there are illuminations about why it is an Islamic imperative to address and problem of poverty and what are the solutions (e.g., using zakah, awqaf, etc.), but what is either absent or inadequately addressed is any explanation or understanding of the nature of poverty and why poverty exists and persists. Even where the causes of poverty are discussed, the explanation is not rooted in any empirical knowledge. [IRTI, undated]

Lastly, even with all the success with the microfinance programs, ultimately poverty alleviation programs through NGOs have limits and they have to be part of a development and poverty reduction strategies at the national level. If poverty alleviation cannot be altogether a private sector market-based activity due to the profit bias, some “quasi-market” would be necessary since “microfinance will only realize its potential if it is integrated into a country’s mainstream financial system.”[Copestake, 2007:1721]

Weiss and Montgomery summed up the current research on effectiveness of microfinance in the following manner:

Despite the current enthusiasm in the donor community for microfinance programmes, rigorous research on the outreach, impact and cost-effectiveness of such programmes is rare. Design of aid programmes would ideally incorporate evidence on all three points, but the research that does exist generally focuses on only one of these criteria: either outreach, impact or cost-effectiveness. In part this reflects the difficulty of establishing an appropriate statistical methodology and implementing those standards in practice, and in part no doubt reflects the variation found in practice in the way in which microfinance operates. Critical to establishing impact accurately is the need for an appropriate control group. The evidence surveyed here suggests that the conclusion from the early literature, that whilst microfinance clearly may have bad positive impacts on poverty it is
unlikely to be a simple panacea for reaching the core poor, remains broadly valid. Reaching the core poor is difficult and some of the reasons that made them difficult to reach with conventional financial instruments mean that they may also be high-risk and therefore unattractive microfinance clients. None the less, reaching the "better off" poor or potential micro-entrepreneurs with microfinance services remains an important element in a poverty reduction strategy. The implication is rather that, for the core poor, it will not be credit alone that will be required, but credit plus a range of support services. [Weiss and Montgomery, 2005:412-413]

The current state of knowledge about poverty and microfinance lends strong credence to the claims that microfinance does help in poverty alleviation, especially to certain segments of the population in poverty. However, it is now well documented and there is growing recognition that there are also significant limitations of microfinance program to have sustained effect on the target groups, to cover all those in poverty, to address both the issues of escaping poverty (ladder) as well as preventing falling into poverty (snake), [Kabeer, 2004; Sen, 2003] and last but not the least, to help sustained gain in the standard of living of those escaping poverty. Indeed, some authors also caution about overexcitement about microfinance.

… over-excitement of impact of microfinance in poverty alleviation tends to undermine the long-term role of microfinance in the sustainability of MFIs. The failure of development banks and the adverse impact of distortions in rural financial markets … have caused emphasis to be placed on sustainability of microfinance institutions as a process of developing rural financial markets and sustaining credit facilities for the poor households. ... However, the development sociologists view the contribution of microfinance and microfinance institutions as the process of reducing the role of the state in financial markets. [Khalily, 2004:335]

Microfinance, as it is traditionally designed, is known as the “minimalist approach”, where credit services are delivered “to the poor either for smoothening of consumption or for the income generating activities … The major objective of this approach is to solve the problem of unemployment in general and micro enterprise development in particular by supplying financial products.” [Shetty, 2008:88] However, such minimalist approach has generally failed to widely spark the micro entrepreneurship among the disadvantaged segment of the society. Thus, a paradigm-shifting, ‘maximalist approach’ involves targeting poverty through microcredit and other relevant programs by delivering both financial and non-financial services to the poor. In this line of thought the current paper attempts to present the new paradigm for the development of micro enterprises through microfinance within the framework of ‘maximalist approach’. Pertinent empirical studies show that microfinance can be a
great facilitating tool when financial component is accompanied by non-financial services, positively affecting the life and livelihood of the poor. [Shetty, 2008]

Due to these limitations, while microfinance must continue as part of the arsenal against poverty, wider ranging fights against and solutions to poverty must be sought in broader development at the national level, which makes the SMEs particularly important and relevant, as part of “inclusive financial services.” [Barr, et al., 2007]

We discuss SMEs in the next segment. But as part of mapping out solutions in a problem-solving manner, what can the IFIs do in making a difference through microfinance?

Informed about the limitations and challenges pertaining to microfinance, it is now well established that given the right conditions, microcredit borrowers have proven to be more reliable and group lending format also has helped reduce the risk of default. Thus, IFIs, reflecting Islam’s maqasid and spirit (not just compliance of the Shariah in legal terms), should be more aggressive in the microfinance operations. Traditional commercial financial institutions have avoided serving the poor without collateral, considering the higher risk factor. Predictably, they price the risk of microcredit to the poor with a significantly high risk premium. However, since microcredit borrowers have proven that they are not as risky as it is traditionally assumed, the risk-pricing has to be duly adjusted to reflect that reality. Another area in which IFIs can help is to target the family or the couple as a borrower team, instead of targeting only the females, which in many cases has contributed to tension in otherwise traditional families. Also, given that microfinance can help an individual borrower up to certain level, the graduated borrowers [Basher, 2007] – those rising above the poverty line – should have further opportunities for themselves or by pooling with others to pursue next level or SMEs. Indeed, many microfinance institutions (MFIs) are already moving toward individual borrower-lender relationship in preference to group lending. [Babu and Singh, 2007]

Poverty Alleviation, Development and SMEs

Since this paper is from an Islamic perspective, it is important to note that generally speaking Islamic economics and finance assumes the following: (a) money is only a medium of exchange and thus should be treated merely as a numeraire (a basic standard by which values are measured) [Usmani, 2002, xiv, 45; Choudhury, 1997; Ghannadian and Goswami, 2004]; (b) Islamic financial transactions must be asset-backed. [Usmani, 2002; El-Hawary, et al., 2004; Abdel-Khaleq, et al., 2007]

The above two premises are important to underscore a fundamental economic reality that the economy operates through interaction of the real sector and the money sector. If money is regarded as a numeraire and an economy, however inefficient, can function without any money, economic development is also essentially a real
phenomenon. Another word, economic development, in its strictly economic dimension, involves simultaneous growth in production and consumption or supply and demand. In such real sector development, expansion of capital assets is a must, for which finance is needed, but it is only a component, albeit a critical one. For an equitable development the capital ownership should be widespread, a point that we discuss further later in this paper.

Real sector development requires transformation of the economy through modernization of all the vital sectors. Production needs to not only grow, but be modernized as desired and appropriate in specific contexts. The consumption has to grow as part of enhancing the standard of living of the population, which would be tied with the production sector. Keeping the connection between the two – production and consumption – at the real level is a key to maintaining stable economic growth. Indeed, countries that have developed went through the relevant transformation and are engaged in perpetual struggle to stay on course and manage the recurrent economic fluctuations to the best of their ability.

Countries in the grip of poverty or widespread deprivation of basic needs need to experience that desired transformation, which requires transformation of institutions, infrastructure, general capacity building, technological change, etc. All participating actors - consumers, producers, government, NGOs, etc. - as well as each financial actor– financial intermediaries, investors, etc. - have a role to play. If the political system is unstable, corrupt and excessively inefficient, or production system is overly traditional (unwilling to embrace or pursue the desired transformation), or the resource allocation does not reflect the true needs and interests of the broader population, or the rule of law does not prevail to provide secure business and investment environment, then no one participating group – government, NGOs, financial institutions, investors, or foreign donors – can facilitate the desired process.

In those respects development is a broad process, which cannot be discussed in detail in this paper. My focus is particularly on poverty alleviation and the role of the financial institutions. Each participant in the economic process has a relevant role to play and if poverty reduction is the focus of a society, then financial institutions – even with profit motive or commercial orientation – can identify relevant intervention points and play their facilitating role – without compromising or jeopardizing their essential economic objective: to make profit.

Identifying the relevant intervention points is critical in the context of the path to development mapped out and then playing the desired role. Before getting to that part, it should be mentioned that the failure of the national government in providing the desired leadership is a fundamental challenge, or impediment. Indeed, often the government and the political establishment have been obstacles to development. This has led to greater participation of the NGOs to fight poverty, especially through
microcredit, which has proved beneficial. However, as pointed out in the discussion about microfinance, there are limits to the benefits of microfinance in fighting poverty – limitations that are inherent in microcredit as well as that are due to non-economic factors, such as lack of facilitating leadership from the national government and pertinent institutions. While the microfinance remains an accepted and valuable part of a society’s arsenal to fight poverty, in broader development, which is essential to poverty reduction, the role of SMEs are also vitally important and in a mapped out framework, that role must be dealt with.

Similar to microcredit, there are many questions and conflicting studies about SMEs. However, generally several arguments in favor of promoting SMEs are noted: (a) SMEs have positive effects on competition and entrepreneurship, allowing widespread benefits in terms of enhancing productivity, efficiency and innovation; (b) SMEs can be more productive than large firms; (c) SMEs might have more favorable employment effect, as those tend to be relatively more labor intensive. [Beck, 2005] Especially, the last argument of better job creation effect has direct implications for poverty reduction. There are counter-studies challenging these arguments, but most of these are in the context of developed countries, where SME vs. large enterprises would have different profile and place than in developing countries.

SMEs are more relevant to poverty reduction through broader approach to development because relative to microcredit based enterprises, SMEs generally enjoy economies of scale, better benefit from technological changes, enhance the economic transformation through modernization and so on. SMEs’ merits do not obviate the needs for targeted PRS through microfinance; instead, when SMEs evolve in the context of national, poverty-focused agenda and environment, they can be more effective in increasing the standard of living and helping people rise out of poverty. They are all relevant as part of “inclusive financial services,” which “does not require that everyone who is eligible use each of the services, but they should be able to choose to use them if desired.” [United Nations Staff, 2006]

The experience with the relative performance of SMEs vary, [Lyberaki and Pesmazoglou, 1994] but several aspects of SMEs in the context of development are notable. First, successful expansion of SMEs involves infrastructure, technology and people in an interrelated manner. Just as SMEs need a conducive culture, SMEs also reshape the culture of the business and society. Second, skills, attitudes, behavior, and operating methods play a much stronger role in case of SMEs relative to smaller scale microfinance projects involving 1-5 people at the basic level. Third, modernization of

---

5 It should be noted that technological change here does not imply wholesale and indiscriminate transfer and adoption of technology from the world shelf. Rather, relevant technological change should benefit from the knowledge base about “indigenous,” “intermediate” and “appropriate” technology. See Basu and Weil, 1998; Akubue, 2000; Farooq, 1988.
an economy requires transformation involving management capabilities dealing with “satisfying employees' growth needs, delegating responsibility, and participative management.” [Lin, 1998] For developing countries SMEs become the right size for experimenting and enhancing the relevant capabilities. Fourth, the notion of ‘work environment’ requires a scale that is far beyond individual-focused microfinance enterprises. Countries with spectacular success with SMEs have nurtured conducive working environment, which has proved instrumental for the transformation toward modernization and widely shared benefits. [Lin, 1998] Modern economies in a globalized world have to be sensitive to market trends and generating as well as allocating the resources in a relevant manner. Obviously, microcredit projects focus mostly at the limited local market, often without being able to take advantage of any networking or scales.

In developing or emerging economies SMEs have a special role to play, since they “potentially constitute the most dynamic firms in an emerging economy. They are the ones most likely to move into areas of comparative advantage and high value added …” [Pissarides, 1999:519] The kind of contributions expected from SMEs simply cannot be expected from microfinance-based enterprises, as exemplified in the experience from Sri Lanka.

The microenterprise earnings of microfinance clients in southeastern Sri Lanka are linked to their initial incomes. Poorer clients face geographic, financial and sociocultural barriers to entry to the most promising microenterprise occupations, leading them to select low-value activities with poor growth prospects. In semi-urban areas, poverty impacts could be strengthened by supplementing loans with nonfinancial interventions encouraging poor clients to select higher-value occupations. In arid rural areas, where microenterprises face severe market and infrastructure constraints, microenterprise development is unlikely to facilitate poverty exit. [Shaw, 2004:1247]

Financial aspects are particularly important because while the constraints that SMEs face often include economic, institutional and legal ones, some studies find the “lack of finance constitutes the main obstacle to the growth of SMEs.” Of course, any help address this constraint requires context-specific solutions, yet it is important to note that there is no “one size fits all” solution. As Pissarides points out, solution requires tailoring “financing instruments to the stage of transition of the country in question and the ability of the local financial system to assume key responsibilities.” [Pissarides, 1999:519]

If the development and spread of SMEs are to be duly supported, it should be noted that financing requirement for SMEs is much greater in scale than for microcredit. Even more important is the greater risk SME-level entrepreneurship and its financiers
face. If IFIs are to be major players in this area – and they should be – then identification and management of the pertinent risk need to be addressed. Since a genuine and effective development would require participation of all relevant parties – individuals, businesses, the government, etc. – playing their role, the mapping out of the role of every group of actors in ensuring adequate provision of capital and appropriate management of risk would be vital.

As a paper like this cannot be of such scope for mapping out all the aspects, some pertinent aspects are mentioned here as examples. When utilizing SMEs as part of the broader development effort, wherever appropriate, the emphasis should be on creating greater employment opportunities, while at the same time adopting and adapting appropriate technology. Besides being the supplier of capital, the IFIs can serve as a catalyst to have positive employment and technology effect. Just like the government can create a structure of fiscal and other incentives for those businesses or SMEs that can corroborate their greater potential for employment effect, financial institutions can also further reinforce the same through better contractual terms in providing capital. For this purpose the seekers of capital must be required to address these concerns in their project proposal as part of the applications for funding. IFIs as equity participants have even greater potential to serve as positive catalyst in this regard.

Also, government as well as financial institutions can serve as a catalyst in another area. One of the major reasons why poverty perpetuates, or even with microfinance-based poverty alleviation programs the target groups often get over the poverty line but cannot make sustained progress toward further prosperity, or that even with national growth and development significant portion of the population is bypassed and inequality widens is because most people have limited participation in equity ownership in capital. While many other aspects of Binary Economics--especially the theoretical foundations beg further questions, at least in one area its diagnosis merits special attention. BE argues that lack of participation in capital ownership is one of the key reasons behind limited number of people benefiting from the fruits of development and this is because productivity (Binary Economics, prefers the term ‘productiveness’) is now achieved through an overwhelmingly greater contribution of capital than other factors of production. In this regard, businesses can draw on the experience of other parts of the world or simply be motivated by Islamic impetus to allow employees to be equity holders in the company. This is not a matter of mandating by the government, but rather creating awareness, environment as well as incentive regime to induce businesses to adopt Employee Stock Ownership Programs (ESOPs) for some well recognized, long-term benefits. [Kruse, et. al., 2003; Klein,

6 BE recognizes only two factors of production, labor and capital, where other two generally recognized factors, land and entrepreneurship are subsumed of the only two factors, labor and capital. The term ‘Binary’ comes from the notion that factors are only two.
According to some of the studies, “employee-owned firms create jobs three times faster than their conventional counterparts” [Rosen and Klein, 1983:15] and such companies also often experience positive investor effect. [Conte, et al., 1996] If a society values creation of better employment opportunities and businesses are induced to facilitate employee participation in the growing capital stock of the society, from broader socioeconomic perspective, income and wealth of the society would be better shared, standard of living in a society will increase and in turn businesses themselves would benefit from the overall prosperity. From the viewpoint of the financial institutions, either in providing capital or having equity participation, risk associated with the companies with ESOPs vis-à-vis the ones without, should be lower. Workers-cum-equity holders of a company should be more devoted, loyal and satisfied workers, who would also understand the difficulties of a business during bad times, unlike in business environments defined by inherent owner/management vs. workers conflict the cost of business can be much higher and as a result the risk could be also greatly enhanced. This is evidenced by many big companies in the USA (such as automaker, airline industries, for examples), where in the pursuit of their own interest the organized labor in the form of unions often have pushed major corporations to raise the compensation and benefits to levels that have proved not just unsustainable, but also disastrous not just for the company, but also for the labor unions themselves.

With lower risk for companies offering ESOPs the pricing of financial products must be different, reflecting the lower risk. This requires modifications to pricing framework as well as cost-benefit analysis. In contrast with the traditional cost-benefit analysis, such as the USAID’s logical framework approach, the World Bank’s economic cost-benefit approach and even distributionally-sensitive economic cost-benefit analysis suggested by others, the approach developed by Amartya Sen where benefits are defined by contributions to human capabilities might have greater relevance to decision-making pertaining to projects affecting development in general and poverty alleviation in particular. [Clements, 1995]

Of course, these aspects cannot be achieved with microfinance or merely targeting poor section for marginal crossover above the poverty line. SMEs can be more relevant in this regard as part of an integrated national development approach and strategy. IFIs not only have a vast opportunity here, but they also have an obligation, because they are or claim to be ‘Islamic’.

Achieving growth needs to accompany better income distribution. In the long run, the link is very important, because “equally compelling, though less pervasive, has been an essentially harmonious relationship between the growth of per capita GDP, macroeconomic stability, and a better distribution of income.” [Naqvi, 1995:543]
Conclusion

The main theme of this paper is that much of the efforts toward poverty alleviation are not from a problem-solving perspective, especially by IFIs where it is primarily prohibition-driven. The paradigmatic shift needed to solve the problem of poverty would involve total commitment of a society, where all the relevant actors (people, businesses, and government) would have the synergy to confront the challenge of poverty with a sense of purpose and urgency. There are many societies where the government itself is one of the leading impediments to genuine development. In such societies the non-governmental sectors have rightfully and desirably stepped in to meet the challenge, but their focus often being through microfinance – despite all their successes – also has serious limitations. IFIs are new to the field and thus have the opportunity to benefit from the accumulated experience. However, being primarily prohibition-driven and dominated by rent-seeking financial enterprises, they have serious limitations to be able to rise up to the monumental challenge. As its focus and primary goal is to offer financial products and services that are shariah-compliant, its commitment and effort in the field of development of those parts of the world where the need for development is most is marginal at best.

The desired paradigmatic shift for meeting the challenge of widespread poverty requires total mobilization of the society, where awareness, policies, institutions, tools, etc. come together to decisively confront the challenge. [Sachs, 2005] In such context, everyone has a relevant role to play. People cannot simply pay zakah or zakah/sadaqat al-fitr and not be concerned or involved, to find out what impact it had in the society in the long term and how. They cannot feel satisfied that they have discharged their religious duties by paying their dues. Rather, they need to be personally engaged through the political, economic, cultural and social processes as part of mapped out solutions. Actor need to know what relevant role they can play and what are some of the critical intervention points, where they can make the most difference. It is not the task financial institutions in general and IFIs in particular to solve by themselves the problem of poverty, but each actor has a relevant role to play. It just happens that being the financiers or providers of capital there are pivotal intervention points where IFIs can serve as catalysts, as part of a mapped-out solutions.

In a recent, contemporary textbook on Islamic finance, a leading scholar of the field wrote: “As the main theme of the Islamic economic system revolves around care of the poor and socio-economic justice, studying Islamic economics should be a strategic activity for economists and policymakers.” [Ayub, 2007:27] If it is “the main theme”, the issue of poverty and socio-economic justice has to be the central focus of the society, and Islamic finance must also be duly interfaced with that “main theme.” Unfortunately, that paradigmatic shift at the level of thought is yet to occur, especially as the field of Islamic finance has eclipsed the broader field of Islamic
economics, and at the level of reality it is still a distant dream awaiting the adherents of Islam to turn it into a reality.
Bibliography


Farooq, Mohammad Omar, Toward Our Reformation: From Legalism to Value-Oriented Islamic Law and Jurisprudence, Herndon, Virginia: International Institute of Islamic Thought, 2009a, forthcoming.


Hudon, Marek, "Should Access to Credit be a Right?," Working Papers CEB 07-008.RS, Université Libre de Bruxelles, Solvay Business School, Centre Emile Bernheim (CEB), 2007.


