

PRO-WELFARE FINANCIAL INTERMEDIATION THROUGH INSTITUTIONALISATION OF ZAKAT AND WAQF

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Abstract: *Social welfare in Islamic framework is not handicapped by notions of consumer sovereignty, Pareto efficiency and Kaldor-Hicks and Scitovsky compensation criteria which do not violate Pareto efficiency. Social welfare in Islamic framework is also not myopic to not address issues of inequality. Economic teachings in Islam urge individuals to care for others and thus recognize externalities. Islam prohibits welfare-worsening institutions explicitly, such as Riba (interest), Qimar (gambling), Ghaban (theft) and Gharar (uncertainty). It allows price intervention and redistribution of resources. Redistribution is achieved in most part through Zakat (obligatory levy on wealth and produce) which compulsorily distributes wealth periodically from the haves to the have-nots. Beyond the compulsory transfer of a portion of wealth and produce through Zakat-ul-mal (compulsory levy on wealth) and Zakat-ul-ard (compulsory levy on produce of land), the institution of Waqf (perpetual endowment) encourages setting aside private wealth for community needs. This can check the private concentration of wealth and enhance the scale of social safety nets for the poor and thereby enable an increase in their welfare. The paper discusses practical and prospective models of microfinance by embedding Zakat and Waqf in integrated microfinance.*

Keywords: Social Welfare Function, Pareto Efficiency, Inequality, Zakat, Waqf, Microfinance

JEL Codes: D63, I30, O43

1. Social Welfare Function from Islamic Perspective

The economic teachings of Islam put great emphasis on social welfare. The individual economic agents are urged to be cognizant of social welfare while making choices. If a person has surplus wealth, Islam encourages Sadqa (charity) and Qard-e-Hasan (interest-free loan). If a person wants to earn income, Islam disallows such ways of earning income that are harmful to social welfare, such as Riba (interest), Qimar (gambling), Ghaban (theft) and Gharar (uncertainty). Riba brings concentration of capital, asymmetric access to financial

capital and unfair distribution of payoffs between lenders and borrowers. Qimar discourages entrepreneurial and productive pursuits, and in financial contracts, it results in increased systemic risk. Ghaban and Gharar bring injustice in exchange and thus result in reduced investment in the economy and increased cost of monitoring and litigation to bring about resolution in contracts.

Thus, i) equitable distribution of wealth and income, ii) fairness and transparency in exchange, iii) increased access to financial services, iv) inclusivity of all sections of society in economic growth and v) reducing poverty, hunger and undernourishment of deprived sections of the population, are policy goals in Islamic framework which need primary focus and emphasis. Islamic economics does not regard market mechanism as absolutely supreme. It allows intervention and regulation of the market and market mechanism to achieve the broad policy goals which enhance social and collective welfare.

In contrast, under secular neoclassical economics, Pareto efficiency has nothing to say about the distribution of welfare across people. For instance, giving everything to one person will still be Pareto efficient as long as all resources are fully utilized and there is no deadweight loss. In Edgeworth box, contract curve represents Pareto efficient outcomes no matter whether the distribution is in the middle or in the extreme corners. In addition to that, determining social preferences based on majority voting may lead to intransitive preferences. Varian (2014) shows that majority voting does not always aggregate transitive individual preferences into a transitive social preference. On the other hand, Varian (2014) also shows that rank-order voting can be manipulated by introducing new alternatives that change the final ranks of the relevant alternatives. Since preferences are privately known and only socially revealed in limited ways, manipulation or concealment is possible. Ironically, Arrow's Impossibility Theorem (1951) implies that plausible and desirable features of a social decision mechanism are inconsistent with democracy and need dictatorship.

However, a command system unguided by objective morality in a Godless worldview can be even more inimical than market-based capitalism. Even the communist countries are not able to reduce inequalities and have rather usurped basic freedoms.

In microeconomics of welfare, a Benthamite utility function proposed by Bentham (1890) is presented as the total sum of utilities of all members of the society. In mathematical formulation, welfare (W) is a function of the utilities of all individual members of the society.

$$W(u_1, \dots, u_n) = \sum_{i=1}^n u_i$$

Where u_i gives person i 's utility level. Since this function gives equal weight to utilities of every person, i.e. rich or poor, it disregards inequalities and class differences.

In its cardinal formulation, utility could be replaced by incomes:

$$W = \sum_{i=1}^n Y_i$$

Where Y_i is person i 's income level. Thus, an aggregate increase in income is welfare-enhancing no matter how such an increase in income is distributed. It does not distinguish

between an income transfer from the rich to the poor and from the poor to the rich. To counter this limitation, a weighted sum of utilities welfare function is represented as follows:

$$W(u_1, \dots, u_n) = \sum_{i=1}^n a_i u_i$$

Here, a_i is the weighting factor that can give more or less weight to different sections of the population, such as rich or poor.

In the individualistic utility formulation of Bergson (1938)-Samuelson (1947), social welfare is defined over each individual's bundle of goods by assuming that individuals care about their own bundles and there are no consumption externalities. The welfare function is directly a function of the individuals' utility levels, but it is indirectly a function of the individual agents' consumption bundles.

$$W(u_1, \dots, u_n) = W(u_1(x_1), \dots, u_n(x_n))$$

Where X_i represents person i 's consumption level. Economists give more importance to Pareto efficiency in economic analysis than equity. Part of the reason is that efficiency can be defined more concretely than equity. An economy is considered Pareto efficient if no economic changes can make one individual better off without making at least one other individual worse off.

In Bentham's formulation, one result may be Pareto efficient. But, the problem in this formulation of social welfare function is that it brings an increase in welfare even if there is an increase in only the utilities of rich people. There is no guarantee that a social welfare-enhancing policy will also bring increased welfare to the poorer sections of the population.

Kaldor (1939)-Hicks (1939) and Scitovsky (1941) compensation criteria discuss redistribution in welfare economics, but within the limits of efficiency analysis. At best, policy design focuses on increase in per capita income, i.e.

$$W = 1/n \sum_{i=1}^n Y_i$$

In contrast, the Rawlsian function based on Rawl's 'Theory of Justice' (1971) looks at social welfare as follows:

$$W(u_1, \dots, u_n) = \min\{u_1, \dots, u_n\}$$

In the Rawlsian welfare function, social welfare only increases when the people at the bottom experience an increase in utility. In its cardinal formulation, welfare increases when the poorest person's income increases.

$$W = \min\{Y_1, \dots, Y_n\}$$

Amartya Sen's cardinal measure of welfare also incorporates income inequality by stating that welfare increases with a rise in average income ($\bar{Y}$) and with a decrease in income inequality (represented by the Gini index, i.e. G).

$$W = \bar{Y}(1 - G)$$

Even though it is a fairer way to formulate social welfare function, the way to get policy commitment to foster this is absent in free markets. The market mechanism can preserve certain kinds of equity in comparison to the unsystematic distribution of welfare without opportunities for exchange. When exchange is allowed in competitive markets where initial endowments are identical, the post-trade allocation leaves both agents in an envy free (in other words, equitable) state. Exchange in competitive markets is shown to be Pareto-efficient (Varian, 2014). However, it requires that the original allocation is equally divided since only then their budgets can be compared and it can be proven that envy (in other words, sense of inequality) is a contradiction (Varian, 2014). But, that is certainly not the case in the real world. Inequities have increased over time since the middle of the twentieth century. Empirical evidence shows that capitalistic growth experience has brought an increase in inequities (Piketty, 2014).

Moreover, with externalities not factored in the price mechanism, market-based growth has resulted in overexploitation of natural resources and the environment since they are undervalued in the market. Therefore, there is a need for social welfare institutions and mechanisms to achieve equality and sustainability beyond markets.

In the Islamic economics framework, there are institutions like Zakat and Waqf which cater to the need for beyond-market redistribution. Zakat-ul-Mal (Zakat on wealth) compulsorily distributes wealth from the haves to the have-nots with the threshold value of wealth as a divider between who is supposed to pay and who can receive the Zakat funds. Beyond the compulsory transfer of a portion of wealth through Zakat, the institution of Waqf encourages setting aside private wealth for community needs. This can check the private concentration of wealth and enhance the scale of social safety nets for the poor and thereby enable an increase in their welfare. Going forward, an effort is made to discuss the economic potential of Zakat and Waqf and their application in integrated microfinance.

2. Institution of Zakat and its Economic Potential

Zakat is a mandatory obligation on Muslims to pay a part of wealth and produce to specified charitable causes. It discourages keeping wealth idle by redistributing it from the rich to the poor. If a resourceful person keeps wealth dormant, then Zakat will have to be paid on it.

Islam does not allow Riba and Qimar. The ideal behaviour for a person with surplus wealth is to give Sadqa or Riba-free Qard. Nevertheless, if a person wants to have a positive return on investment of surplus wealth, he has to convert his assets into investment capital or return-generating assets. Risk related to investment in business or asset has to be undertaken to deserve any Halal profit and return. In both the situations, the surplus wealth will circulate

in the economy and generate more economic activity through spending and investment. Increase in economic activities will also provide greater employment opportunities. Wealth will flow through the economy in both situations, leading to increased expenditure and utilization of idle resources like labor and physical capital.

The payer and receiver of Zakat are divided based on a threshold value of wealth known as Nisab (Metwally, 2011). This wealth is equivalent to the monetary sum of 612.36 grams of silver in wealth. This threshold ensures that the payer and receiver belong to two different sections of the population so that the redistribution of wealth is from the rich to the poor.

Poor people usually have greater unmet needs and they are expected to spend more of the marginal increase in income as compared to the rich (Ghassan, 2016). It is anticipated that this redistribution from the population segment with a lower marginal propensity to consume to the population segment with a higher marginal propensity to consume will increase overall consumption and, consequently, aggregate demand. Ben Jedidia and Guerbouj (2021) have found in an empirical study of eight Muslim majority countries that Zakat stimulates economic growth. In an empirical study of transition countries, Shoukat and Zhu (2021) found a similar growth-enhancing impact of Zakat. For Indonesia, Athoillah (2018) has found that not only Zakat has a significant and positive effect on growth, but it also has a significant and negative effect on poverty.

The redistribution of wealth through Zakat does not result in receive and hold paradox, i.e. receiving and not spending the Zakat funds. Since it is paid to the poor with greater marginal propensity to consume, it results in greater spending and boosts aggregate demand. In poverty alleviation, potential Zakat collectible at the national level is found to be sufficient in plugging the poverty gap in several Muslim majority countries (Shaikh, 2016). Several studies have found that Zakat enhances the welfare of the recipient households and helps in poverty alleviation (Azam et al. 2014; Malik et al., 1994). Zakat not only addresses poverty alleviation but also ameliorates income inequality (Ibrahim, 2006).

This institution also has several beneficial uses in enhancing financial inclusion. Poor people are underfunded by banks due to low income, smaller asset ownership and lack of adequate skills for entrepreneurship. Through financial transfers, Zakat increases the income of the impoverished, increases asset ownership through asset transfers, and boosts skills through grants for education and training funded by Zakat. Some studies have found that if financial transfers through Zakat are complemented with human capital development, then the effect on poverty reduction can be more significant (Abdelmawla, 2014; Norazlina & Rahim, 2011). Therefore, if Zakat can be embedded in providing financial services to the poor along with non-financial services, it can help in improving socio-economic mobility. Several authors in the literature have emphasized embedding Zakat with other institutions, such as microfinance to enhance the impact and benefit from cost and scale synergies (Hassan, 2010; Shirazi, 2014).

3. Wealth Redistribution through the Institution of Zakat

The institution of Zakat is effective in checking wealth accumulation and concentration. Consider this dynamic deterministic model of wealth accumulation to appreciate how Zakat decays the private idle wealth of the rich. Zakat functions as a proportional capital charge on net wealth (above a specific threshold, the Nisab), applied at a fixed lunar annual rate. For monetary wealth and tradable assets, this rate is 2.5%.

Let $W(t)$ represents the total eligible private wealth of a wealthy individual at time t (measured in years). In a standard economic framework, wealth grows via an expected net rate of return on investment, r . Consumption in each period is given by $C(t)$. Assuming the individual's wealth remains safely above the Nisab threshold, the rate of change of wealth over time can be modeled as:

$$\frac{dW(t)}{dt} = rW(t) - C(t) - zW(t)$$

Where,

$W(t)$ is the private wealth at time t .

$r > 0$ is the annual rate of return on Halal investments.

$C(t)$ is the consumption at time t .

z is the continuous Zakat rate.

To analyze the impact of Zakat, we compare a baseline scenario (No Zakat) against the Zakat scenario ($z = 0.025$). Let consumption be a linear function of wealth, $C(t) = cW(t)$, where c is the marginal propensity to consume out of wealth ($0 < c < 1$). Substituting $C(t)$ into the differential equation gives:

$$\frac{dW(t)}{dt} = (r - c - z)W(t)$$

This is a first-order linear ordinary differential equation. Solving this by separating variables with an initial wealth $W(0) = W_0$:

$$W(t) = W_0 e^{(r-c-z)t}$$

When there is no Zakat, we get:

$$W(t) = W_0 e^{(r-c)t}$$

When there is Zakat, we get:

$$W(t) = W_0 e^{(r-c-0.025)t}$$

To show that Zakat reduces private wealth relative to the baseline at any time $t > 0$, we evaluate the ratio of the two scenarios:

$$\frac{W_{\text{Zakat}}(t)}{W_{\text{Baseline}}(t)} = \frac{W_0 e^{(r-c-0.025)t}}{W_0 e^{(r-c)t}} = e^{(-0.025)t}$$

Because $z = 0.025 > 0$ and $t > 0$, it follows that $e^{(-0.025)t} < 1$. Therefore: $W_{\text{Zakat}}(t) < W_{\text{Baseline}}(t)$

This proves that the presence of Zakat mathematically guarantees a lower private wealth stock at any future point in time compared to an identical macroeconomic environment without Zakat.

4. Institution of Waqf and its Economic Potential

Within the framework of Islamic economics, Waqf is a significant social institution. An owner contributes and dedicates a movable or immovable asset to the Waqf institution for the long-term benefit of society. The usufruct and/or income are permanently enjoyed by the recipients. Real estate, furniture, vehicles, other transportable goods, and liquid assets like cash and stock can all be used to create a Waqf.

Waqf comes in a variety of forms and can be categorized according to its assets, period, and purpose. There are three types of Waqf in terms of its purpose: family, philanthropic, and religious (including mosques and religious institutions). Some academics support the idea of temporary Waqf, yet Waqf can also be permanent. When it comes to assets, Waqf might be of either cash or property. Waqf can be utilized to provide infrastructure and services related to food, sanitation, education, health, and hygiene facilities like public baths.

Kuran (2001) admits that Waqf provided public goods and services in a decentralized way. Hence, the institution engages community and does not depend on whether the political system supports public goods and services provision or not. Koehler (2014) concludes that Waqf provided an institutional blueprint on which endowment based universities of Europe were built. Before the modern welfare states, which mostly rely on high levels of average per capita income and marginal tax rate, Waqf was successful in delivering public welfare services in Muslim countries. In later centuries, the reasons of decline include state control and colonialism (Joseph, 2014).

Waqf, unlike trust in secular law is more deeply influenced by the spirit of pure altruism and cooperation. The Waqif (endower) is moved by the spirit of altruism, cooperation and solidarity and dedicates his/her private property for the greater benefit of people at large in current and future generations. It is one reason why Awqaf (plural of Waqf) have been resilient and long lasting. The original spirit of the endower is preserved in management of Waqf since it is not allowed to deviate from the Waqf deed in which Waqif prescribes the beneficial use of the endowed asset.

Deaton (1991) demonstrates that consumers may be able to employ buffer inventories to get a high degree of consumption-smoothing in the absence of home credit markets. In this sense, Waqf offers a way for society to formally distribute its buffer stock resources for both immediate and long-term requirements. Resources that are surplus and not required for immediate consumption are known as buffer stock resources. If the wealthy offer their excess resources for the public good rather than hoarding them, more people will be able to use them to meet their needs.

According to Khan (2019), the Waqf institution can give priority to financing small enterprises that are encouraging environmentally friendly practices and exploiting natural resources wisely because the majority of its donors are not motivated by profits. Waqf will thus support the Sustainable Development Goals and Maqasid-e-Shari'ah (Abdullah, 2018).

Donations of cash for a long-term social good are made through the Cash Waqf. It can be used to collect monetary contributions for the construction of facilities including hospitals, schools, and orphanages (Sadeq 2002). Cash Waqf can guarantee a greater number of individual donors and aggregate more resources (Aziz et al., 2013). Unlike Zakat, where funds must be used for certain recipient categories, Waqf offers more latitude in how monies are used. Numerous welfare services, including educational, health, and environmental preservation programs, as well as financial institutions like Waqf-based microfinance (Habib, 2007) and socially conscious banks (Mohammad, 2011), can be provided by the Waqf institution.

According to Mukhlisin and Mustafida (2019), Musari (2019), and Fauziah et al. (2021), Cash Waqf-Linked Sukuk has the potential to raise money for commercial or quasi-commercial initiatives and endeavors by combining investment and philanthropic motivations. Sukuk are securities which represent undivided ownership stake of Sukuk holders in some underlying asset. By virtue of selling the asset on profit or providing its usufruct for rent, the Sukuk holders can potentially earn return in proportion to their stake in the underlying asset.

Three problems with that innovation, however, are identified from an economics perspective: i) the cost of double intermediation in comparison to the marginal benefits; ii) the loss of flexibility in the allocation of funds when the dual motive is involved; and iii) the increased fiscal burden if the government issues it and is expected to cover the returns gap.

Furthermore, Shirazi (2014) and Saiti et al. (2021) propose a worldwide transnational Waqf led by the Islamic Development Bank to effectively distribute resources to meet the socioeconomic requirements of the Muslim Ummah, particularly during times like the Covid-19 pandemic.

To escape poverty and attain social mobility, impoverished individuals need education and skills in addition to income support and financial transfers. According to Haneef et al. (2014), in order to unleash the potential of micro-entrepreneurs and create successful micro-enterprises, institutional support is necessary due to a shortage of funding and business training. According to Obaidullah (2008), growth-oriented microfinance initiatives must also offer opportunities for skill development, insurance, and training. In this sense, the Waqf institution can increase the likelihood of socioeconomic mobility by offering a relatively

stable, efficient, and effective source of funding for the infrastructure of education and health. Waqf-funded health and education facilities can be expanded and upgraded, which can increase beneficiaries' capacity to earn revenue.

5. Wealth Redistribution through the Institution of Waqf

The institution of Waqf has a potential to reduce wealth inequality by transferring private wealth to the use by community members at large. Let $W_H(t)$ represents the aggregate wealth of wealthy households and $W_L(t)$ represents the aggregate wealth of low-income households. The wealthy class earns a return r on their wealth, but they immediately give away a fraction α of their total wealth to the poor. The lower-income class earns a wage growth rate g on their own wealth, plus they directly receive the incoming Waqf transfer (αW_H).

The differential equations representing the transfer are:

$$\frac{dW_H}{dt} = (r - \alpha)W_H$$

$$\frac{dW_L}{dt} = gW_L + \alpha W_H$$

The wealth concentration ratio is given by:

$$R = \frac{W_H}{W_L}$$

Applying the quotient rule of differentiation, we get:

$$\frac{dR}{dt} = \frac{W_L \frac{dW_H}{dt} - W_H \frac{dW_L}{dt}}{W_L^2}$$

$$\frac{dR}{dt} = \frac{W_L[(r - \alpha)W_H] - W_H[gW_L + \alpha W_H]}{W_L^2}$$

$$\frac{dR}{dt} = \frac{(r - \alpha)W_H W_L - gW_L W_H - \alpha(W_H)^2}{W_L^2}$$

$$\frac{dR}{dt} = \frac{(r - \alpha)W_H W_L}{W_L^2} - \frac{gW_L W_H}{W_L^2} - \frac{\alpha(W_H)^2}{W_L^2}$$

$$\frac{dR}{dt} = \frac{(r - \alpha)W_H}{W_L} - \frac{gW_H}{W_L} - \frac{\alpha(W_H)^2}{W_L^2}$$

We know that $R = \frac{W_H}{W_L}$

$$\frac{dR}{dt} = (r - \alpha)R - gR - \alpha R^2$$

$$\frac{dR}{dt} = R[(r - \alpha - g) - \alpha R]$$

In a standard capitalist economy ($\alpha = 0$). Hence, the equation becomes:

$$\frac{dR}{dt} = (r - g)R$$

As found by Piketty (2014), $r > g$ in a capitalistic economy, the ratio grows forever.

However, with the Waqf factor ($\alpha > 0$), the equation takes the exact mathematical form of a Logistic Growth Equation. It will eventually stop growing and stabilize at a point where the change in the ratio becomes zero ($\frac{dR}{dt} = 0$). Using this, we get

$$0 = R[(r - \alpha - g) - \alpha R]$$

$$\alpha R = r - \alpha - g$$

$$R = \frac{r - \alpha - g}{\alpha}$$

$$R = \frac{r - g}{\alpha} - 1$$

Without Waqf ($\alpha = 0$), the cap on inequality is infinite. But by introducing a constant community endowment factor ($\alpha > 0$), society mathematically guarantees a ceiling on wealth concentration. For example, if capital returns are $r = 7\%$, wage growth is $g = 3\%$, and the wealthy donate $\alpha = 2.5\%$, the wealth gap will lock into a permanent steady state and never exceed a ratio of 60%:

$$R = \frac{0.07 - 0.03}{0.025} - 1 = 0.6$$

6. Prospective Zakat and Waqf-Based Microfinance Models

Waqf is also useful for setting up financial institutions for public welfare, such as microfinance institutions. Some microfinance institutions like Akhuwat in Pakistan generate funding based on the model of Cash Waqf, but they do not use the term ‘Cash Waqf’ due to the non-recognition of Cash Waqf in law. After obtaining funds from both private and public sources, Akhuwat offers its clients interest-free loans known as Qard-e-Hasan. The clients then commit to repaying the Qard amount at a predetermined future date. A small, fixed fee that is independent of the loan amount is assessed for the documentation, processing, and screening of the applications. With over 800 offices throughout Pakistan, Akhuwat currently serves 6.3 million people. Through its more than 300 schools, it is providing education to around 50,000 students. Figure 1 illustrates the Akhuwat’s Qard-e-Hasan model.

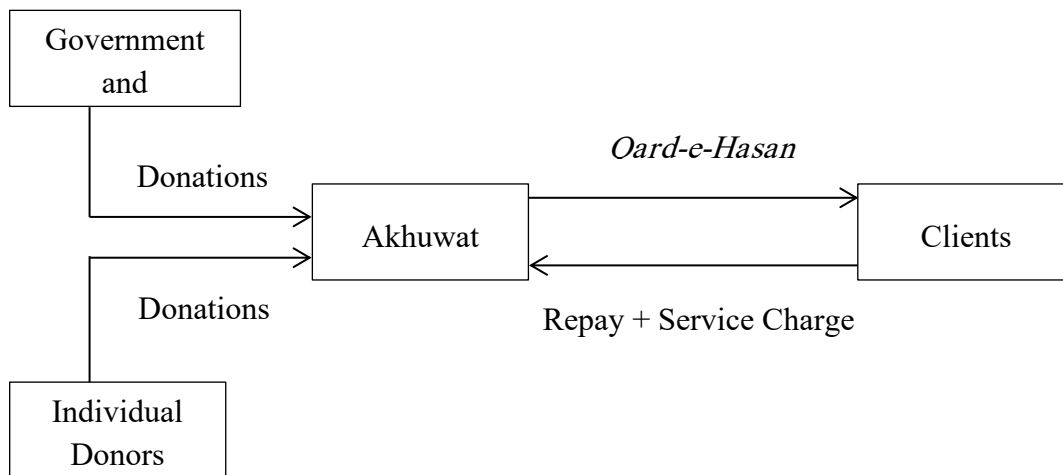


Figure 1. Akhuwat Interest-Free Loan Microfinance Program

In order to ensure food security and to support food supply chain, Waqf can also be utilized in agriculture. Waqf-based food bank will collect cash and in-kind donations along with Ushr from the institutional and individual donors. The amount pooled in the Waqf can be invested for returns as well as used to purchase food from farmers. The staple food purchased from the farmers can be distributed among the poor and needy. It will support the objective of ending hunger (SDG 2), ensuring food security (SDG 12) and providing decent growth and employment opportunities (SDG 8) to the farmers. The Waqf-based food bank model is illustrated in Figure 2.

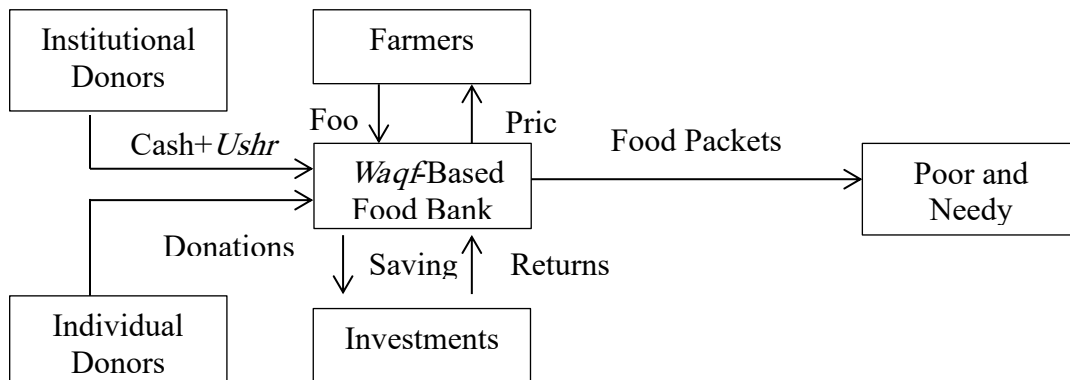


Figure 2. Waqf-Based Food Bank

In scaling operations, there is a need for more financial resources as well as human resources. Such can be mobilized through synergistic partnerships and collaborations. A prospective Cash Waqf-Based Islamic Microfinance Model (CWBMF) is illustrated in Figure 3.

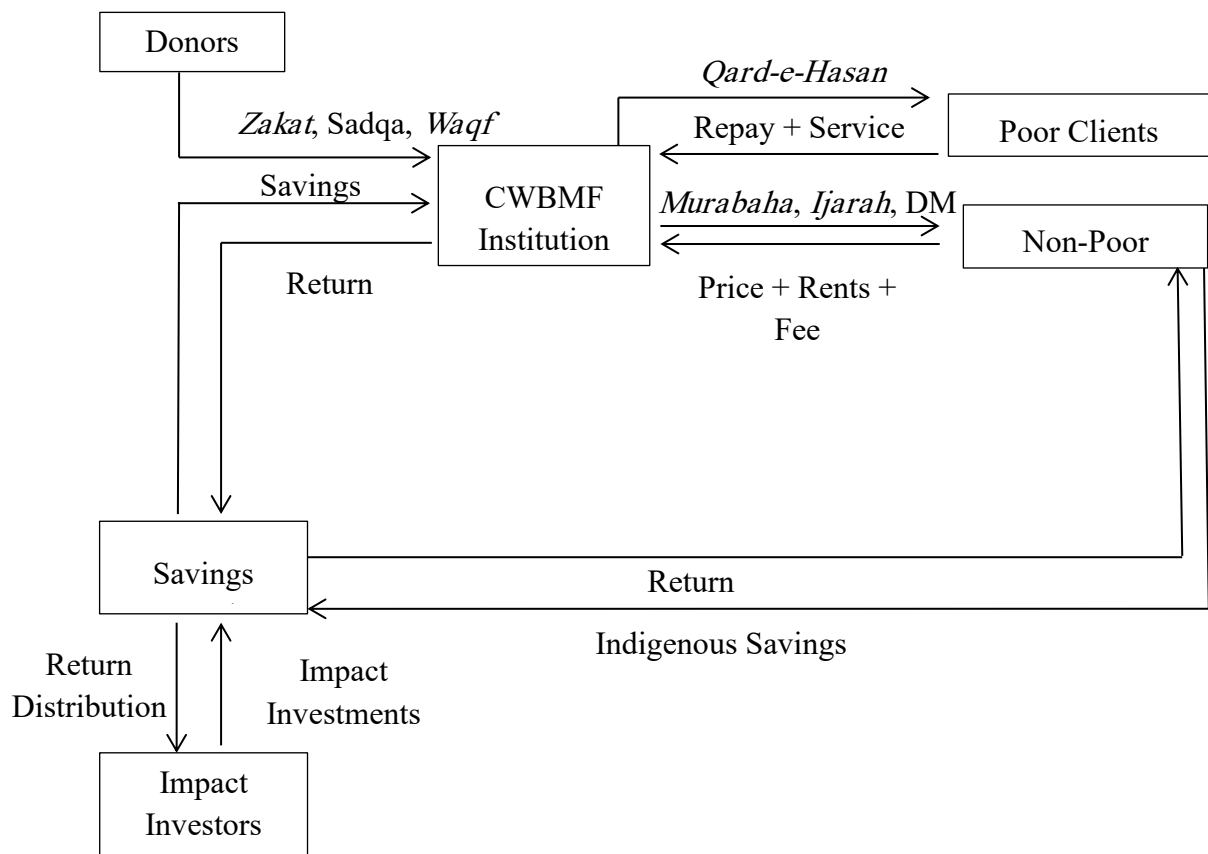


Figure 3. Cash Waqf Based Micro Finance (CWBMF) Model

It mobilizes financial resources through i) cash donations with pure altruism motive and ii) impact investments. Impact investors look for dual investment objectives, i.e. doing well economically by doing what is morally good. On the financing side, clients are segregated into poor and non-poor. Poor clients are served with Qard-e-Hasan without any extra financial burden. Non-poor clients are eligible for financing through Islamic trade and lease-based modes of finance, such as Murabaha (deferred payment sale), Ijarah (asset lease leading to acquisition) and Diminishing Musharakah (asset financing on declining equity basis). Non-poor clients will also be encouraged to engage in micro-savings and such impact investments will provide an indigenous source of funds as well.

The above model can be further strengthened by extending the service network and engaging i) volunteer trainers and educational institutions for capacity enhancement, ii) Takaful institutions and hospitals for health risk management and iii) retail stores for subsidised purchases. This engagement in such a microfinance program will provide not only financial support but also non-financial support in the form of capacity building, health risk management and subsidised purchase of essential goods to manage affordability. This will require joint ventures (JV) between the microfinance institution with retail stores, Takaful institutions, hospitals and educational institutions. Such institutions in civil society will be forthcoming to play their part as most of these institutions are not profit-based institutions. Figure 4 illustrates the Integrated Cash Waqf Based Islamic Microfinance Model (ICWBMF).

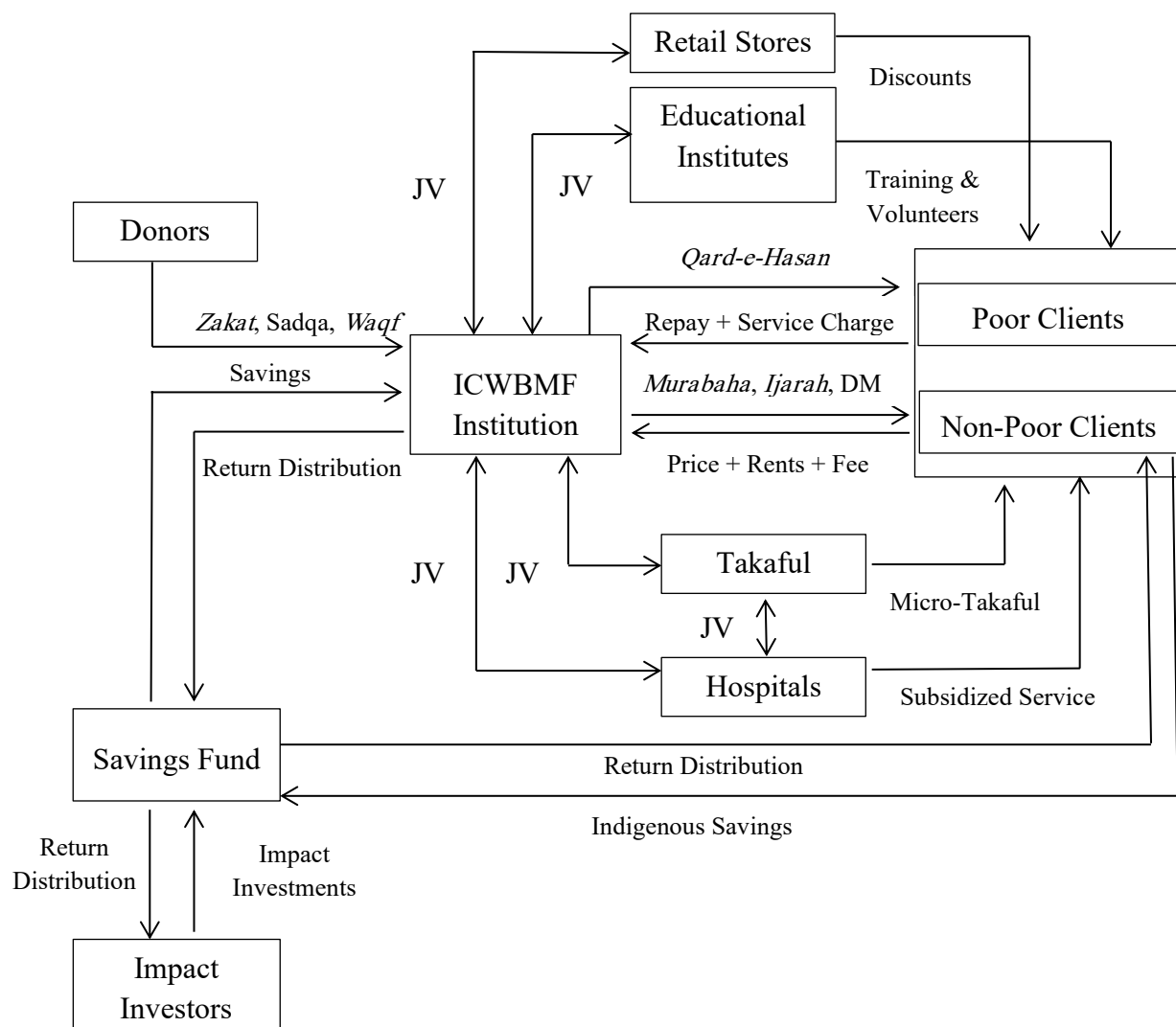


Figure 4. Integrated Cash Waqf Based Micro Finance (ICWBMF) Model

In addition to that, universities can also promote micro-entrepreneurship by setting up a Cash Waqf-based micro-entrepreneurship Waqf fund. In most business schools, there is a business incubation centre. Universities already provide education which enhances human capital and business acumen. They can also become the funding arm for start-ups of their graduates by getting funds from alumni, corporate sponsorships and charity from Islamic banks.

The easier and less risky model is where financing for start-ups is provided through Qard-e-Hasan. Through a partnership with an Islamic bank for Phase II, successful start-ups can qualify for financing via banks which show notable progress and potential in the pilot phase (Phase I).

Therefore, universities will be feeding the banking sector with potential businesses which can be provided with commercial finance after training and the pilot phase on Qard-e-Hasan-based funding from the university's micro-entrepreneurship Waqf fund. Since universities grant the degrees, this can also provide social collateral to the financial

institutions. If a start-up wilfully and deliberately defaults, the degrees of involved persons can be annulled. The micro-entrepreneurship Waqf structure is illustrated in Figure 5.

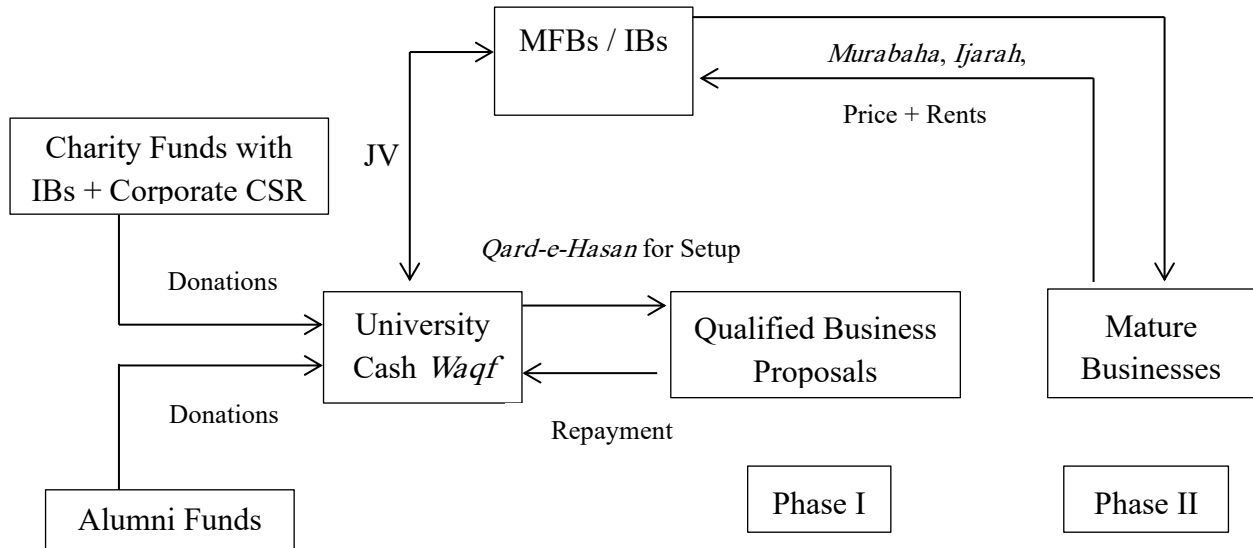


Figure 5. Financing Start-ups Using Qard-e-Hasan

If universities gain experience and capacity to engage in inclusive financing, they can also adopt the Mudarabah (venture capital) and Musharakah (partnership) model as well to provide seed capital in Phase I financing. In the accelerated financing stage of Phase II, microfinance banks and Islamic banks can be engaged to provide financing to help the start-ups scale, expand and accelerate growth. The financing structure using Mudarabah is illustrated in Figure 6. In this structure, the university's micro-entrepreneurship Waqf fund will become the Rabb-ul-Maal (capital investor) and the micro-entrepreneur will become Mudarib (working entrepreneur). Profit will be shared as per profit sharing ratio. Performance is incentivized by the prospect of enhanced financing from banks in Phase II to enable expansion and acceleration.

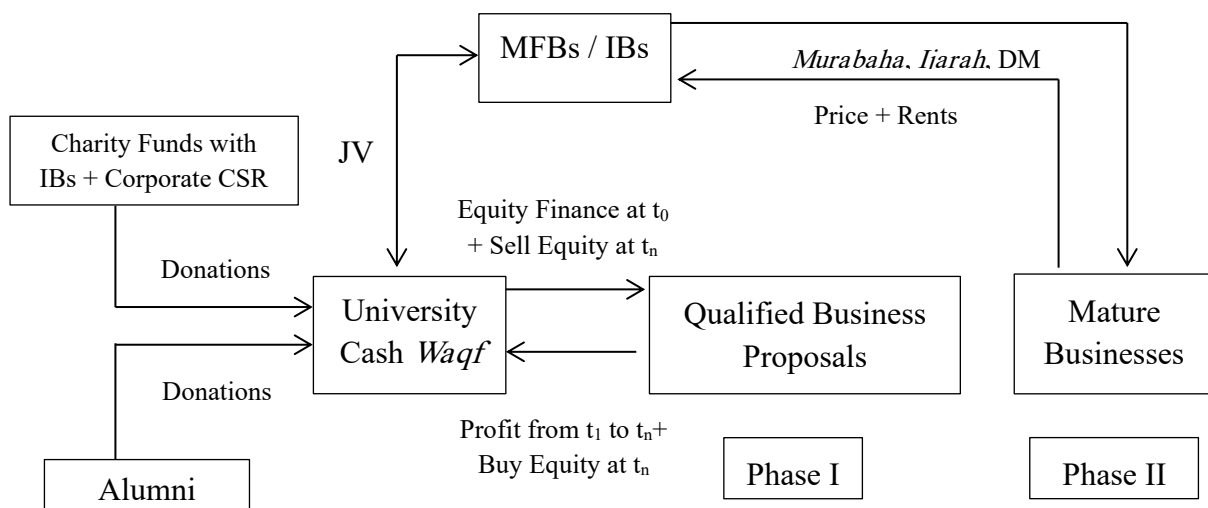


Figure 6: Financing Start-ups Using Mudarabah

In Mudarabah, all the financial risk is borne by the Rabb-ul-Maal. In order to mitigate financial risk and enable risk-sharing as well as ensuring the commitment of the micro-entrepreneur, the Musharakah model can also be used. In this model, the micro-entrepreneur will also have to invest some capital and share the loss as per the capital contribution ratio. This will enable risk sharing and greater commitment and exertion of efforts from the micro-entrepreneur to avoid the situation of losses as much as possible.

7. Conclusion

This paper discussed the incapability to address issues of inequality in social welfare function in mainstream neoclassical economics. It gives more focus to Pareto efficient outcomes while overlooking consumption externalities in Bergson-Samuelson individualistic utility formulations. Redistribution through Kaldor-Hicks and Scitovsky criteria is also handicapped by the emphasis on Pareto efficiency. The policy framework allows institutions like Riba which further exacerbate initial inequalities. In contrast, the Islamic social framework is equipped with objective morality which shapes preferences. It avoids welfare-worsening institutions which concentrate wealth (Riba), allocate resources to unproductive pursuits (Qimar) or which hamper trade (Ghaban and Gharar). It has built-in redistributive institutions, such as Zakat and Waqf which perform redistribution beyond markets.

The paper also discussed how these social finance institutions can be institutionalized in the financial system through integrated microfinance. Through blending social and commercial finance and integrating stakeholders, such as healthcare providers, education providers and Takaful providers, the integrated micro-finance can achieve scale, better outreach and greater impact in terms of enabling socio-economic mobility. The positive externalities are enormous of such a market and beyond-market driven intermediation of commercial and social intermediaries using the instruments of Islamic commercial and social finance.

The proposed programs can cater to the financial and non-financial needs of the poor as well as non-poor clients more effectively under a single institutional framework. The cost and information synergies will help in economizing on the delivery of services and matching the economic agents more efficiently. The scale and impact can create the network externalities needed for a big-push in scaling up. The commercial financial institutions will also be able to play an effective and meaningful role for financial acceleration. They need to change the mind-set from acting as competitors to become an important player in the value chain.

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