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Impact of Islamic Financial Development on Income Inequality And Poverty in Pakistan

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Abstract
Macroeconomic stability and development of the financial sector are important factors which shape poverty situation and income distribution in developing countries such as Pakistan. The aim of this study is to investigate the correlation between inflation, economic growth, Islamic finance, poverty, and income inequality on quarterly basis for a period 2013–2024 for Pakistan. The primary goal is to examine the effect of macroeconomic variables on poverty and income distribution with the inclusion of Islamic Financial development. The study uses econometric methods to study the short run and long run relationships between the variables under consideration. The findings show that inflation markedly increases both poverty and income inequality, which suggests that inflation has an adverse impact on low income households. On the other hand, economic growth is shown to be a major driver of reducing poverty and income inequality, and therefore inclusive development. Moreover, Islamic finance development has positive relationship with financial inclusion and financial inequality. The results indicate that policy measures such as a stable macroeconomic environment along with growth of Islamic financial institutions can be effective in reducing poverty and enhancing income inequality in Pakistan. The study suggests that Islamic financial systems need to be strengthened, inflation needs to be controlled

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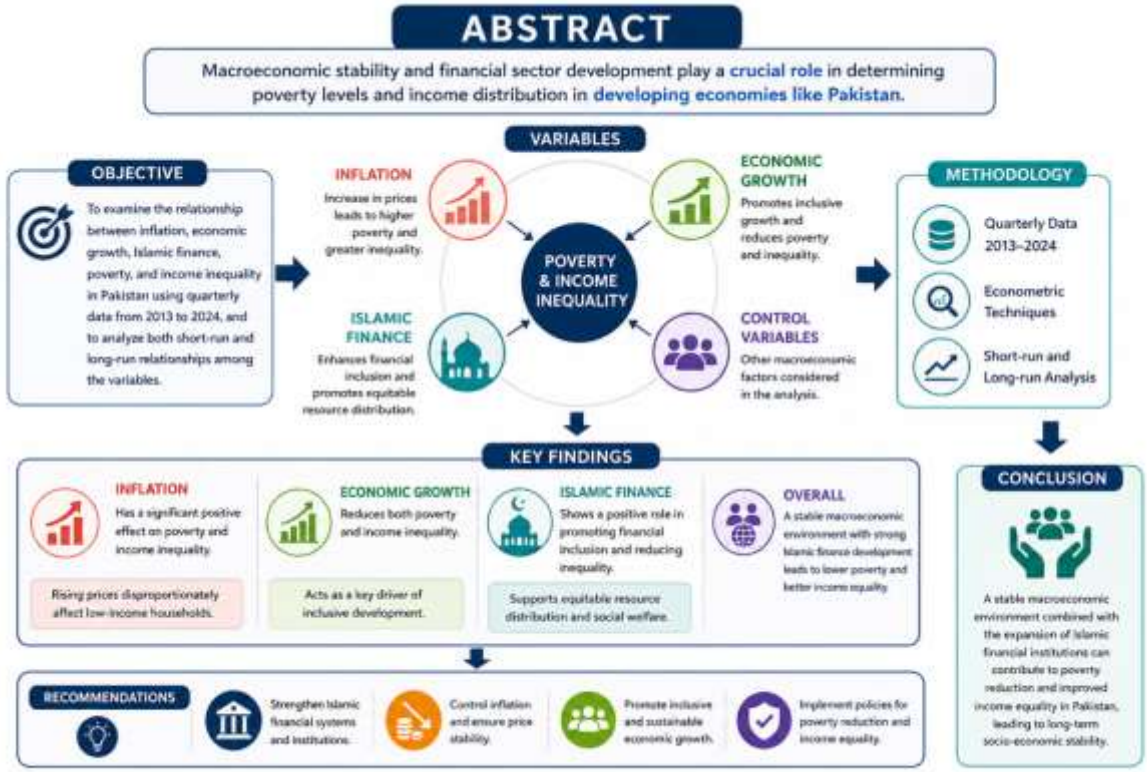
and long-term inclusive economic growth needs to be maintained to attain long term socio-economic stability.

Keywords: Islamic Financial Development, Poverty, Income Inequality



Introduction:

The overall economic development of a nation is heavily dependent on finance because it is the means of bringing together savings, enabling investment, and enhancing the availability of financial services (Mbodj & Laye 2025; Morshed 2025). In the case of a developing country like Pakistan, the financial sector will not only contribute to the economic growth but also help to curb the prevalent developmental issues like poverty and income inequality (Ullah 2025). Nonetheless, the financial development is not always evenly distributed, and a substantial part of the population continues to be financially locked out, particularly low-income households and vulnerable populations (Corrado and Corrado 2017). This predicament poses a significant policy issue whether the growth of the financial sector indeed enhances the well-being of the poor and decreases inequality within the society.

In this context, Islamic finance has emerged as an effective alternative tool for conventional financing development worldwide because it is based on the principles of justice, fairness, risk-sharing, ethical investment, and social welfare (Shahariman et al., 2024) . . Islamic finance discourages exploitative financial practices like riba (interest), and it encourages socially responsible financial practices with the help of such financial instruments like Murabaha, Mudarabah, Musharakah, Ijarah, Zakat,

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Waqf, and Qard al-Hasan (Sadeq, 1997; Iqbal and Mirakhor, 2017; Zaman, Contrary to the traditional financial systems, Islamic finance is theoretically developed not only to make profits but also to equally distribute wealth, social inclusion, and poverty reduction (Aziz and Mohamad, 2016; Zulkhibri and Ismail, 2017) According to a report of the Islamic Financial Services Board (2025), the Islamic Finance is estimated at 2 trillion US dollars, expanding at a rate of By 20242025, the world-wide Islamic finance market is estimated to be between 3.88 trillion and 5.4 trillion. This growth has permeated into key markets such as Southeast Asia, Middle East, Africa, and the Gulf Cooperation Council (GCC) with other nations like Malaysia, Saudi Arabia, Kuwait and even the United Kingdom emerging as strong Islamic finance ecosystems. These global tendencies refer to the fact that Islamic finance is no longer a small financial system, but a more and more significant part of the world financial growth.

Figure 1.1 : Islamic Finance industry Breakdown

Source: Al Huda Centre of Islamic Banking and Economics **(2025).**

Islamic finance has shown impressive and consistent growth over the past years with the current global assets of about USD 5.2 trillion which is increasing with an average of about 14.9 percent annually- a far greater increase compared to the average yearly increase of just one digit in most traditional financial markets. This expansion is mainly because of the dominance of Islamic banking that comprises approximately 72% of the industry and the Sukuk with 18 percent with other components such as the Islamic fintech, Takaful, capital markets, and microfinance having lesser yet gradually rising percentages. Other factors that contribute to the momentum of the industry include increasing Sukuk issues, fast digitalization of Shariah-compliant financial services, and activating operations in new markets, especially in Africa and

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selected parts of Europe. In the future, the total assets of the global Islamic finance are estimated to be more than USD 6 trillion in 2026, indicating the strength and stability of this sector based on real economic activities and absence of interest-based and speculative practices (AlHuda Centre of Islamic Banking and Economics, 2025; Islamic Financial Services Board, 2025).

Islamic finance is a Shariah-compliant framework that forbids Riba (interest), Gharar (excessive uncertainty) and Maysir (gambling) (Wahab, 2023). It lays emphasis in risk sharing, asset backed transactions, and ethical investments. It is run on the principles of Sharia (Islamic law), in which money is regarded as an exchange medium and not a commodity that can be sold to make a profit. The idea of Islamic finance was first presented by Ahmed Elnaggar in 1963. In Pakistan, however, Islamic finance came with the initiatives of changing the traditional banking and financial system into an Islamic one that started in the 1980s. Interest-free banking on the national level was one of the few countries that Pakistan was attempting to implement at the time. Several steps were made in the early 1980s to promote this initiative and several banking and other related legislations were revised to support the interest-free banking initiative in the nation. This project was comprehensive but not very successful in developing a complete Sharia compliant system (State Bank of Pakistan 2026).

However, Pakistan reintroduced Islamic banking in 2001, when it was resolved to propagate Islamic banking step by step and as a parallel and compatible system in accordance with the best International practices. Therefore, the Islamic Banking Department (IBD) was set up at State Bank of Pakistan (SBP) with a brief to design and reinforce the regulatory and Shariah-compliance base of Islamic banking as well as lead the initiative of the promotion of the industries as an alternative and feasible banking system. Likewise, in December 2022, the State Bank of Pakistan created an Islamic Financial Group with two departments, the Islamic Financial Policy Department (IFPD) and the Islamic Financial Development Department (IFDD). The overall aim of IFDD is the management of seminars or workshops to generate market awareness regarding the Islamic banking, planning and conducting capacity building workshops to the concerned stakeholders, the monitoring of the Islamic banks transformation plans into an Islamic bank, facilitation of development of innovative products like asset-like Sukuk structures, etc., and strategic partnership with the domestic or international stakeholders in the field of Islamic Finance.. Another duty of the department was to enhance the Islamic money market by solving liquidity management problems to the Islamic banking industry (State Bank of Pakistan 2026).

Islamic finance has become a developing center in Pakistan, which commands about 2 percent of the world Islamic finance market, with an estimated value of $3.9 to 5.3 trillion dollars. On the same note, the Islamic banking assets in Pakistan were at Rs. nationally. By March 2025 11.5 trillion in total banking Assets, 21.1% market share of total market share of total banking Assets and 24.2% of deposits. It has 4,731branches and 171 sub-branches (State Bank of Pakistan 2025).

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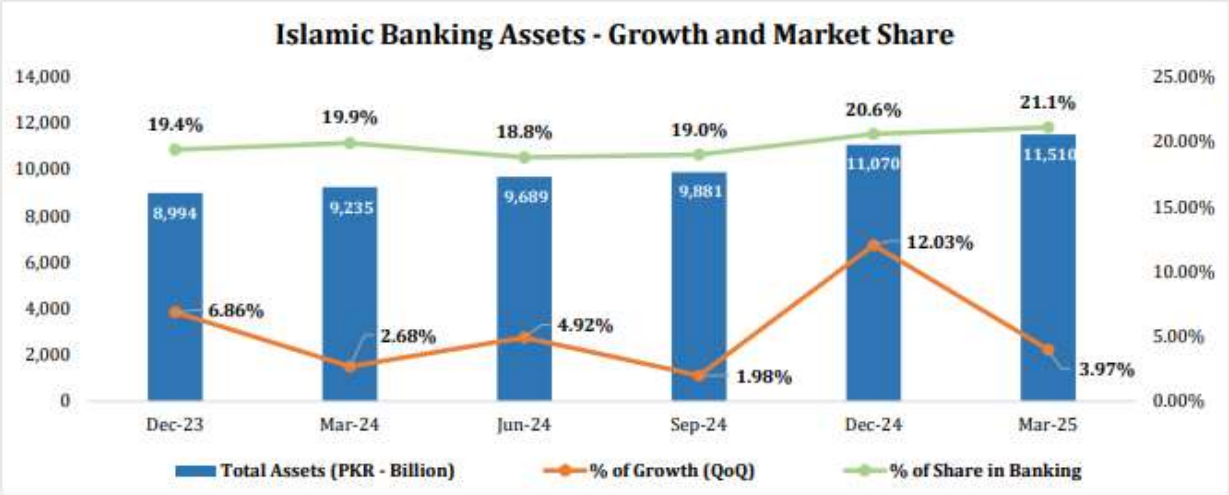
Figure 1.2: Islamic Banking Assets



Source: State Bank of Pakistan. (2025)

Figure 1.2 demonstrates that Islamic banking assets in Pakistan grew steadily between PKR 8,994 billion in December 2023 and PKR 11,516 billion in March 2025, which suggests a steady growth of the sphere. Meanwhile, the market share of Islamic banking within the total banking industry also increased, as it grew by 19.4 to 21.1 that indicates the increasing significance of this banking model to the financial system. The quarter-on-quarter growth rate was in a fluctuating pattern throughout the period with the highest and lowest rates of 12.03 and 1.98 percent in December 2024 and September 2024 respectively, but the general tendency confirms that Islamic banking assets in Pakistan were moving positively and increasing (State Bank of Pakistan, 2025).

Inequality and Poverty Situation in Pakistan

In Pakistan, socio-economic problems of poverty and income inequality have become significant and have posed significant challenges to inclusive and sustainable development. Even with the growth of the economy and the development of the financial sector, a significant percentage of the population has inaccessible income opportunities, productive resources, and basic social services. Current data indicates that income and wealth are still very concentrated among a small group of people. The World Inequality Report (2026) states that in Pakistan, the top 10 percent of the population earns approximately 42 percent of the national income and controls almost 59 percent of the total wealth, with the bottom 50 percent earning about 19 percent of the total income. This lack of equality is a manifestation of the deep-rooted inequality in the country. Similarly, the recent Gini coefficient of Pakistan also reflects the ongoing income inequality where it is believed that the fruits of economic activity are not equally distributed in the society.

Meanwhile, poverty is a significant issue in Pakistan and has aggravated over the last few years. The latest estimates by the world bank and the official Pakistani

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institutions show that the situation of poverty has been more alarming. In 2026, preliminary estimates given by the planning authorities in Pakistan show that the national poverty rate has grown significantly than in the past years. Equally, the poverty ratings of the World Bank reveal that a good percentage of the Pakistani population is below the lower-middle-income poverty threshold, and many individuals have multidimensional poverty, which entails lack of access to education, health, housing, and living standards. These circumstances imply that poverty in Pakistan is not merely a low-income problem, but a more general development problem that is associated with poor access to both economic and social opportunities. Thus, the continued existence of poverty, as well as inequality, indicates that general financial and economic growth has not necessarily led to the equitable welfare results. In that regard, the role of Islamic finance is especially critical due to the fact that it is frequently introduced as a financial system that facilitates social justice, inclusion, and fair wealth distribution. Islamic finance is theoretically supposed to serve to alleviate poverty and income disparity through the promotion of risk sharing, ethical investment, entrepreneurship and redistributive processes including zakat, waqf and qard al-hasan. Nevertheless, due to its increasing growth, there is still poor empirical research on the welfare effects of Islamic finance, particularly in Pakistan. Most of the available literature has concentrated on the performance, growth, and efficiency of Islamic banking as opposed to how it has helped in poverty alleviation and income distribution in the society (Obid & Naysary, 2014; Wahab, 2023). Furthermore, the available international literature indicates that even though financial inclusion and Islamic financial development may enhance socio-economic results, they have varied impacts between countries and institutional contexts (Omar and Inaba, 2020; Seven and Coskun, 2016; Durohman et al., 2025). Consequently, it is significant to discuss whether Islamic financial development growth in Pakistan has indeed helped to alleviate poverty and close income inequality.

Statement of Problem

Despite the financial sector expansion and economic reforms, Pakistan has been struggling with severe and endemic socio-economic issues in the form of poverty and income inequality. The percentage of the population who cannot access productive resources, formal financial services, and reliable opportunities to generate income is still high. Recent data show that economic resources are still very concentrated in a limited group of people in society with a large percentage of the population still living in poverty in terms of income and living standards. Meanwhile, poverty is still prevalent and multidimensional, which is a manifestation of the inability not only to generate income but also to have access to education, health, and other vital opportunities. The role of the financial sector is therefore the more crucial in such a situation, especially the financial systems that are likely to encourage inclusion, fairness, and welfare-oriented development. The concept of Islamic finance has been considered as one of such systems, as it is founded on the principles of social justice, fair allocation of wealth, ethical investments, and financial inclusion (Sadeq, 1997; Aziz and Mohamad, 2016; Zaman, 2018). During the past 20 years, Islamic financial

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institutions in Pakistan have grown tremendously in terms of assets, deposits, financing operations and coverage, which shows the increasing significance of Islamic financial growth in the banking system of Pakistan. However, it is not yet clear whether this growth has positively affected the welfare of the lower income groups or minimized socio-economic inequalities in Pakistan. The Islamic banking sector in Pakistan is already valued at PKR 11.51 trillion in asset and PKR 8.42 trillion in deposits by March 2025, which highlights the level to which the sector has grown in the national financial system.

Despite the theoretically anticipated poverty and inequality reduction mechanisms of Islamic finance based on risk-sharing, social finance, and inclusive financing, the empirical data is sparse, inconclusive, and inadequate, particularly in the case of Pakistan. Most of the past research has concentrated on the performance, growth, efficiency, and operation aspects of the Islamic banking instead of the overall welfare impact (Obid & Naysary, 2014; Wahab, 2023). There are also mixed findings of international empirical studies. Considering the example, Omar and Inaba (2020) discovered that financial inclusion is a key factor in reducing poverty and income inequality in developing nations, whereas Seven and Coskun (2016) found that the impact of financial development on poverty and inequality is uneven across emerging economies. Equally, Durohman et al. (2025) determined that Islamic financial development reduces income inequality in OIC countries but Novreska and Arundina (2024) established that Islamic financial inclusion has a significant effect on poverty but insignificant on income inequality. In Pakistan, the role of Islamic finance in economic growth and financial sustainability was mostly discussed in studies by Naz and Gulzar (2023), Nawaz et al. (2019), and Iqbal and Fikri (2024), whereas Shahbaz and Islam (2011) were interested in conventional financial development and income inequality. Hence, there is an obvious empirical gap on whether the Islamic financial development has any significant influence on poverty and income inequality in Pakistan. This research aims at filling this gap by empirically examining the association between Islamic financial development, poverty, and income inequality in the Pakistani context.

Organizations Of Study

To offer a concise systematic analysis, this study is divided into five major sections. Section 1 presents the study, background, problem statement, objectives and significance. Section 2 examines theoretical and empirical literature on the relationship between Islamic financial development, poverty and income inequality, and establishes gaps in research. Section 3 provides the methodology, which consists of research design, data sources, variables, and econometric techniques. The data analysis, results, and the discussion are provided in the Section 4, and the main results, policy implications, and recommendations to the future research are presented in the Section 5.

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Literature Review

The section assesses the available literature regarding the effects of Islamic financial development on income inequality and poverty in Pakistan. This section is primarily aimed at knowing what past researchers discovered regarding the concept of Islamic finance, poverty alleviation, and allocation of income distribution. It discusses the ways through which the Islamic financial development including the development of Islamic banking, Islamic financing and Shariah-based financial services can be used to enhance the economic status of the people by enabling more people to access finance and also by promoting social welfare. This part also addresses the international and Pakistan-related studies to demonstrate the correlation between Islamic finance, poverty, and inequality. Besides, it also gives the research gap that is filled by past researches and why this study is significant. Overall, this chapter will offer both theoretical and empirical preconditions of the current study.

Theoretical Literature Review

This paper is based on three closely correlated theoretical views that are Financial Intermediation Theory, Financial Inclusion Theory, and Islamic Economic Justice Theory. All these theories create a powerful conceptual framework in explaining how Islamic financial development can affect poverty and income inequality in Pakistan. Financial Intermediation Theory is used to explain how financial institutions can get the savings mobilized and direct funds to productive investment to enhance economic opportunities and well-being. The Financial Inclusion Theory builds on this perspective, pointing out that the returns to finance are higher when the benefits of access to financial services are extended to poor, marginalized and hitherto locked-out populations. Parallel to that, Islamic Economic Justice Theory introduces a normative and welfare-focused angle with the argument that finance must enhance justice, equitable wealth distribution, social welfare and safeguard of vulnerable groups. These channels are usually described in the Islamic finance literature as being particularly applicable in Muslim-majority economies, where Shariah-compliant finance can enhance access to households and firms that do not use conventional finance as well as to instruments of inclusion like zakat, waqf, qard al-Hasan, and Islamic microfinance (Zulkhibri and Ismail 2017).

Financial Intermediation Theory

The Financial Intermediation Theory describes how the financial institutions act as an intermediary between surplus (savers) and deficit units (borrowers) in the economy. This theory argues that banks and other financial institutions harvest deposits by individuals and other institutions who have excess funds and invest such excess funds to those who need capital to invest, produce, consume, or entrepreneurial activities. By so doing, the financial intermediaries lower the transaction cost, enhance liquidity, mitigate risk and allocate the financial resources more efficiently within and without the economy. According to the theory, an established financial system will help the economy to grow through mobilizing the savings, capital formation as well as investing in productive activities. At the development level, this process has the

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potential to boost employment, business, household, and general wellbeing (Scholtens and Van Wensveld 2003; Rejekiningsih et al., 2022).

In this paper, the role of Islamic financial institutions is to do the same the intermediation, but in a Shariah-compliant way. Instead of lending out in the form of interest, Islamic banks and other Islamic institutions of financial services mobilize the deposits and offer finances in form of the Murabaha, Mudarabah, Musharakah and Ijarah. Thus, the theory applies since it promotes the notion that Islamic financial development can help to increase access to finance, facilitate constructive economic action, and increase welfare provision. If Islamic intermediation thrives in Pakistan, poor households and small businesses can gain access to financial sources through the financial intermediation, which can be used to alleviate poverty and income disparity.

Financial Inclusion Theory

According to Financial Inclusion Theory, finance development goes beyond the financial sector size alone as to whether or not people can access and utilize financial services. Highlighted in the theory, households and firms (low-income households, women, rural households, and small businesses) should be affordably and readily served by services, including savings, payments, credit, insurance, and financial transfers. The wider the access, the more financially excluded individuals can ease consumption, risk management, investment in health and education, small business start-ups, and more economic life will be involved in economics. There is a growing empirical body of evidence that general financial inclusion is linked to the reduction of poverty and personal earnings inequality, but the impact varies according to other increasingly important conditions, such as education, inflation, and the quality of institutions (Omar and Inaba 2020).

This theory is most applicable in the current work as the Islamic financial development can facilitate the financial inclusion in Pakistan by providing Shariah-compliant financial services to those who shun conventional banking due to religious or ethical motivations. Islamic finance could also assist in increasing the number of people who are constitute a substantial portion of the population and are therefore out of the formal financial system by making them more trusting, accessible and acceptable of the financial services. It is through this medium that Islamic financial growth can potentially aid in development in entrepreneurship, self-employment, household stability, and income-generating activities among the low-income groups of individuals, thus establishing a means towards poverty reduction as well as inequality of income.

Islamic Economic Justice Theory

Islamic Economic Justice Theory offers the most robust normative framework to the current study since it considers economic and financial systems as a means of profit generation as well as a means of social justice, fairness, welfare and equitable wealth distribution. According to the Islamic economic thinking, economic activities are supposed to be directed by principles (justice), ihsan (benevolence), and protection of the rights of all members of the society especially of the weak and vulnerable. Islamic

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finance is thus set to prevent the exploitative aspects of riba (interest), excessive uncertainty and socially destructive speculation, and promote risk-sharing, asset-backing, ethical investment, and socially responsible distribution of resources. The fixation of the wider Islamic finance literature on the role of redistributive and solidarity-based instruments, such as zakat, waqf, sadaqah, and qard al-Hasan, in minimizing deprivation and helping to promote inclusive welfare has also been noted (Iqbal and Mirakhor 2017).

Applied to this research, the Islamic Economic Justice Theory indicates that the proliferation of Islamic financial institutions and instruments should, preferably, help to reduce poverty and evenly allocate income. This is possible when the channels of Islamic financial development brings resources to productive sectors, small businesses, underserved populations and welfare increasing activities instead of focusing on already advantaged groups. Thus, this theory can directly underpin the expectation that the development of the Islamic finance in Pakistan can alleviate the poverty and income disparity in case it will be consistent with the social and ethical goals.

Integrated Theoretical Link With The Study

The combination of these three theories means that the anticipated decay between Islamic financial development, poverty and income inequality in Pakistan is anticipated. The Financial Intermediation Theory describes the mobilization and distribution of funds within the Islamic financial institutions in an efficient manner. Financial Inclusion Theory describes the way forward on the welfare of the marginalized and the poor through the increased access to their services. The Islamic Economic Justice Theory further justifies why Islamic finance, specifically, should provide greater support to equity, inclusion, and social welfare than financial systems that are based on entirely on profit motives. On the premise of these theories, the given study presupposes that the development of Islamic finance can alleviate poverty as well as decrease income inequality by making the access to Shariah-compliant financial services more productive, by facilitating the development of small businesses, and by promoting socio-economic justice. Nevertheless, the theories also suggest that these would not happen automatically; these would rely on whether Islamic finance actually becomes a reality in reaching the poor and the underserved. This renders the empirical research in Pakistan case important and imperative.

Empirically Literature Review

The empirical knowledge on the relationship between financial development and poverty, as well as financial development and income inequality, has been quite substantial, but the results are inconsistent and context-dependent. There are studies that propose that financial development lowers poverty and inequality through the provision of access to credit, investment, creation of employment, and financial inclusion. Conversely, other researchers believe that financial development can enhance inequality in case the financial resources are concentrated in the hands of the upper-income groups, urban regions, and financially advantaged persons. Over the last few years, there has been a growing interest by scholars in the Islamic financial

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development especially in the Muslim dominated and OIC countries in exploring the possibility of whether this development would play a more mediating role in the equal distribution of income and poverty alleviation.

Jamiu et al. (2025) is one of the latest works in this field as it analyzed the effect of Islamic banking on the redistribution of sustainable income in four countries that actively use Islamic banking, that is, Saudi Arabia, Malaysia, Indonesia, and Nigeria. The research used structured interviews as the source of primary data, which is composed of 400 respondents who have been divided into 100 respondents in each country. The analysis was conducted by both quantitative and qualitative approaches with the assistance of case studies. The results have shown that Islamic banking plays a major role in wealth redistribution and economic justice using methods like zakat, waqf, and profit sharing. The research identified Islamic banking could not be simply an alternative to the traditional finance, but also being one of the essential tools to meet the objective of sustainable and equitable income redistribution.

In the same way, Durohman et al. (2025) examined the long-run impacts of Islamic financial development, human development, and country risk on the income inequality in 13 OIC countries between the year 2013 and 2023. The research further empirically verified the hypothesis, which is the Islamic Financial Kuznets Curve (IFKC) applying the Fully Modified Ordinary Least Squares (FMOLS) and Dynamic Ordinary Least Squares (DOLS). The findings indicated that the development of Islamic finance brings about a significant decrease in income gap and has a non-linear inverted U shape relationship, hence justifying the hypothesis of the IFKC. The implication of these findings is that at the initial stages of development the Islamic financial development can increase the inequality, although once the sector matures, it will increase the equity of the income distribution.

Muhammad et al. (2025) in another related qualitative study examined how Islamic financial products (Qard al-Hasan, Zakat, Waqf, Mudarabah, and Musharakah) can ensure economic justice and financial inclusion among the marginalized communities. Purposive sampling, documentary analysis, content analysis and case study were methods used in the study to assess the role of Islamic financial institutions in contributing to inclusive growth. The paper has found that inclusion of Islamic finance into the national financial inclusion policies would have a long-term sustainable solution in alleviating poverty and achieving fair growth. The research is in a qualitative format, but it gives firm conceptual arguments in support of the socio-economic role of Islamic finance.

Novreska and Arundiana (2024) empirically tested the practical significance of Islamic financial inclusion in alleviating poverty, income disparity, and the human development issues in 33 Indonesian provinces between 2014 and 2022 at the regional level. It was a study based on the annual panel data, in which the measures of poverty included poverty rate, income inequality, Gini index, and human development measured by the Human Development Index (HDI). Islamic financial inclusion was proxied by Islamic banking third-party funds, the number of Islamic bank branches, and Islamic financing, whereas the control variables were the GDP per capita, the years of schooling, and the COVID-19. The findings revealed that Islamic financial

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inclusion is crucial in alleviating poverty and enhancing human development though its impact on income inequality was found not to be statistically significant. This implies that the effect of Islamic financial inclusion on welfare can be enhanced even in cases where the effect on income distribution is not necessarily short-term.

Similarly, Iqbal and Fikri (2024) examined the correlation between Islamic banking processes and economic growth in Pakistan based on information of five Islamic banks in the years 2018 to 2022. The paper has used Pearson Regression Analysis to test the relationship between GDP and Z-score, given different structures of Islamic financing. These findings implied that the use of most of the Islamic financing modes was tightly related with financial sustainability but Murabaha appears to have no correlation with the Z-score. Although the study was not on poverty or inequality per se, it gives a supportive evidence on the argument that the Islamic banking can positively influence the economic and financial environment at large; this can ultimately influence the welfare outcomes indirectly.

Within the framework of Pakistan, Naz and Fikri (2023) investigated the long-term and short-term impact of the Islamic financial development on the economic growth based on the time-series values between 2006 and 2021. The dependent variable was real GDP and the proxies of Islamic financial development were Islamic banking development (IBD), the Islamic bond market development (IBM), and the Islamic stock market development (ISM). The models that were used in the study included the Autoregressive Distributed Lag (ARDL) model, Bounds Test, Error Correction Model (ECM), and Pairwise Granger Causality Test. The results showed that the development of the Islamic banking and the Islamic stock market had a substantial positive relationship with economic growth in the long run whereas; Islamic bond market development did not have any positive relationship in the long run. These findings show that development of Islamic finance can add to the economic performance in Pakistan, which might have implications on the poverty reduction and income distribution.

Zuhroh and Malik (2023) provide a similar view and examined how Shariah financing has contributed to the Sustainable Development Goals (SDGs) in reducing poverty and inequality in Indonesia in 33 provinces between 2012 and 2020. The investigation conducted with the help of Fixed Effect Panel Regression and the Generalized Least Squares (GLS) methodology revealed that Shariah financing minimized poverty levels, financing disparity, and employment opportunity disparities significantly. The findings however indicated that the nominal value of Shariah financing was the only factor that directly influenced reduction of poverty. This means that the amount and availability of Islamic finance is an issue to the socio-economic efficiency of the same. December 2015-2020) time-series data on the same topic. The paper has used ARDL method to estimate short-run and long-term relationships. According to the findings, it was found that Islamic banks played a significant role in reducing the income disparity in both the short-term and the long-term. To increase their contribution to the development of the real sector, the authors noted that Islamic banks need to offer balanced, affordable, and high-quality financing to the real sector.

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Mansoor (2022) which included the effects of financial crisis on income inequality and whether financial inclusion and Islamic banking mitigated this relationship carried out a more global study. The authors of the study analyzed 150 countries between 1980 and 2018 using panel data and System Generalized Method of Moments (System-GMM) and Robust Dynamic Panel Estimation, as well as OLS, GLS, and PCSE, as sensitivity tests. It was found that financial crises greatly augment the degree of income inequality yet minimally in those countries where there is more financial incorporation and a more substantial Islamic banking industry. The research found that Islamic banking and financial inclusion could ensure a moderating role of safeguarding the societies against increasing inequality in economic shocks.

In the same manner, Maizura and Kamarudin (2021) approximated the impacts of financial development and Islamic development on poverty and income inequality in 13 OIC countries based on panel data in the year 2004-2016. The research used Static Panel Data Regression Models, Mediation Analysis and Principal Component Analysis (PCA) to develop financial development indices. The dependent variables were poverty and income inequality with the explanatory variables being financial development and Islamic human development indicators. The findings indicated that financial development in the OIC countries, in particular, bank development and financial inclusion, do not directly alleviate poverty but substantially alleviate income inequality. These results suggest that the influence of finance on poverty can be indirect and it can be done through other socio-economic pathways. Kui et al. (2021) conducted an analysis of how globalization, e-government, financial development, and institutional quality reduce poverty and income inequality in 64 countries in the One Belt One Road (OBOR) initiative between 2003 and 2018. The study by using two-step System-GMM and Driscoll-Kraay standard error regression discovered that globalization, economic growth, development of e-government, government expenditure and inflation have a significant reduction on income inequality and poverty. The study does not specifically study the Islamic finance, but makes the argument stronger that financial and institutional development can have a significant role in enhancing the socio-economic outcomes.

In addition, Mohammad et al. (2020) also examined how corporate social responsibility (CSR) strengthens the capacity of the Islamic banks to mitigate income inequality in the selected 24 OIC countries during 2006-2013. The models employed in the study were fixed-effect, random-effect, and the Generalized Method of Moments (GMM). The dependent variable was the income inequality, and the independent variable was the Islamic Financial Development (IFD), CSR, and an interaction term. These results indicated that Islamic banking could decrease the income inequality, especially when the Islamic financial institutions are performing CSR activities effectively. Nonetheless, it was also found in the study that low levels of CSR engagement could not be adequate to have distributive impacts that are meaningful.

In a study that was highly influential, Omar and Inaba (2020) accessed the effect of financial inclusion on poverty and income inequality in 16 developing countries using annual panel data between 2004 and 2016. The researcher developed a financial

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inclusion index based on a wide range of financial outreach measures. The findings were strong indications that financial inclusion can be used to great effect in decreasing the rates of poverty and income inequality. Though the study was based on overall financial inclusion as opposed to Islamic finance as such, it substantiates the position that increasing access to finances can enhance socio-economic welfare.

In the previous research, Putriani et al. (2019) examined the contribution of Islamic banking to decrease income inequality based on 49 Islamic banks in 13 countries between 2010 and 2015. The analysis used panel EGLS estimation, where the GDP per capita and inflation were used as control variables. Results showed that there was a negative significant relationship between income inequality and financial depth that was measured in terms of total customer deposits to GDP. This implies that more penetration of Islamic banking can help in making income distribution equal.

Similarly, in a study, Akhter et al. (2019) examined both Islamic banking and its influence on financial inclusion in the Muslim countries in Asia and Africa between the years 2005 and 2014. Random Effects Panel Regression on the Hausman specification test was employed in the study under the indicators of bank credit use, bank accounts ownership and savings in bank accounts. The resultant findings indicated that Islamic banking has a central role in the demand side of the financial inclusion meaning that an important part can be played by Islamic finance in terms of integrating the excluded groups of people into the formal financial system.

Khan et al. (2019) examined the correlation between Zakat and financial inclusion on Pakistani time-series data of Pakistan between 1982 and 2015. Ordinary Least Squares (OLS) and Bayesian estimation were used in the study. The results were in favor of the argument that Islamic social finance, especially zakat, could be utilized as an instrument to alleviate financial exclusion, and subsequently, as a means of alleviating poverty and income inequality. This brings out the need to consider both commercial and social aspects of Islamic finance when researching on welfare outcomes.

In the same vein, Mustafa et al. (2018) compared the effects of Islamic finance on economic growth and financial inclusion on the economic conditions in nine leading markets of Islamic finance such as Pakistan based on 2011-2014 panel data. The authors used the Simultaneous Equation Model (SEM) and concluded that Islamic finance positively and significantly affects the economic growth, but the effect on financial inclusion was also positive, but statistically insignificant. The results indicate that though the use of Islamic finance enhances the growth of the macroeconomics, the benefits of its inclusion can be subject to other structural and policy environments.

Omar et al. (2017) also explored the importance of the Islamization Index as a proxy of Islamic orientation in the connection between economic growth and income inequality in Malaysia. The analysis conducted with the ARDL modeling technique indicated that there was a significant long-run correlation between Islamization, income inequality and economic growth. Despite the fact that the research was not directly oriented towards the Islamic financial development, it offers valuable

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evidence that Islamic socio-economic structures could have an effect on the distributive outcomes.

On a micro scale, Aslam (2014) examined the effect of Islamic microfinance in reducing poverty in Pakistan by examining the impact of Islamic microfinance on living standards, per capita earnings, awareness, ethical principles, employment opportunities, and social welfare. The research employed questionnaires as data collection methods and Chi-square test as the data analysis. These results indicated that Islamic microfinance has contributed greatly towards the enhancement of living standards and social-economic statuses of the beneficiaries. The research is especially essential in that it offers first hand evidence of Pakistan to show that Islamic finance can help to reduce poverty at the household level.

Research Gap

Despite a considerable amount of literature on the linkage between financial development, poverty, and income inequality there is still a significant gap in the context of Islamic financial development in Pakistan. Most past efforts have been on traditional financial development, broad financial inclusion, or the growth of the banking sector as opposed to the unique role of Islamic finance in enhancing the social-economic well-being. In particular, Seven and Coskun (2016) discovered that financial development does not need to decrease poverty and income inequality in emerging economies, whereas ReWalk (2022) claimed that financial development has no direct impact on reducing poverty and can even have an indirect influence through inequality. On the same note, Omar and Inaba (2020) emphasized that financial inclusion may be involved to lessen poverty and income inequality, but their paper was informed by the developing economies in general and not specifically about Islamic finance. Such studies are significant, but they fail to clarify whether Islamic financial development has the same or greater welfare effect in a country such as Pakistan.

The literature is still weak and scattered in the Pakistani context. Other studies, such as Mahmood et al., (2017), were able to consider positive impact of Islamic microfinance in enhancing household welfare and also, reducing poverty in Pakistan, whereas Kanat et al. (2024) investigated the impact of overall financial development in alleviating poverty in Pakistan. Nevertheless, these researches are either on micro-level Islamic finance or general financial development and not a thorough evaluation of the concept of Islamic financial development in the macroeconomic level. Additionally, majority of the current research that has been conducted in Pakistan focuses on poverty and income inequality as distinct variables although the two are two related measure of socio-economic well-being. The other significant constraint is that a significant portion of the Pakistani literature on Islamic finance is primarily concerned with the growth, performance, customer satisfaction, or expansion of institutions, and not the effects of its application on poverty reduction and equal distribution of income (Nawaz, 2019). As such, the current paper addresses this significant gap by empirically investigating whether Islamic financial development

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serves to alleviate poverty as well as income inequality in Pakistan through a single empirical model.

Research Methodology

Based on previous studies, this chapter specifies an econometric model to analyze crucial factors that influence income inequality and poverty; the influence of Islamic Financial Development on poverty and income inequality; and the conditional relationships of Islamic Financial Development in reducing poverty and income inequality in Pakistan. We then describe key measurement issues and the compilation of data from different sources. Moreover, we will use the econometric technique to describe the relationship between Islamic financial development and income inequality and poverty.

Theoretical Framework:

The study uses the Quantitative Research Design to explore the impact of Islamic financial development on income and equality, and poverty. The study adopts two theories: Islamic economic theory and the Lorenz curve theory.

The Islamic economic theory says that financial systems are based on Profit-sharing (Modarabah), asset-backing, and compulsory wealth redistribution (Zakat), which reduces income concentration and poverty(Chapra, 2008).Islamic economic theory are gives that Islamic finance which prohibits Riba, Gharar and Maysir leads to,

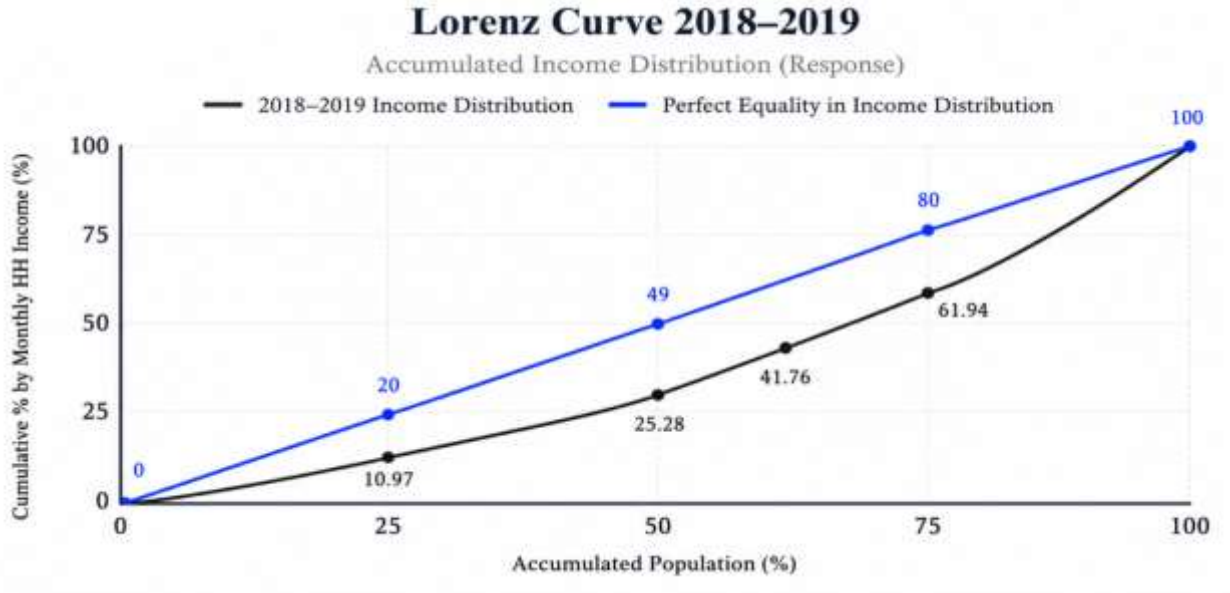
Greater assets and risk sharing.

Reducing the concentration of wealth

Direct redistribution of wealth through zakat (compulsory 2.5 percent on idle wealth)

Zakat funds are directly transferred to the poor, thus reducing poverty.

However, the Lorenz curve theory shows the distribution of income among the households. It visually measures the income inequality.



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The data is collected from the World Development Indicator (WDI) and the State Bank of Pakistan (SBP), covering period from 2013 to 2025 for Pakistan. The data is primarily based on the Islamic financial development and its impact on income inequality and poverty. Previous studies and researches computed that due to the development of Islamic Finance, the income inequality and poverty has reduced(Zuhroh and Malik, 2023; Bashir, 2018; Widodo, 2019; Mohammad et al, 2020; Kareem et al, 2020; Aziz and Mohamad, 2016; Novreska and Arundina, 2024). This study will also describe the impact of Islamic financial development in reducing income inequality and poverty in Pakistan using the time series approach for 50 years. Various methods, approaches, and economic techniques will be used to describe this relationship.

Model of Study

The study have two dependent variables say; income inequality and poverty, so study will have two Econometric models. The studies conducted by Zuhroh and Malik (2023), Novreska and Arundina (2024) indicate that there is a negative relationship between Income inequality and the Islamic Financial Development and between Poverty and the Islamic Financial Development.

In model one is based on the income inequality as dependent variables and economic growth, Islamic financial development, inflation and government expenditure are explanatory variables. Model one as given below.

$$GINI_t = \alpha_0 + \alpha_1 Y_t + \alpha_2 IFD_T + \alpha_3 CPI_t + \alpha_4 GE_t + \in_t$$

In model two is based on the poverty as dependent variables and economic growth, Islamic financial development, inflation and government expenditure are explanatory variables. Model one as given below.

$$POV_t = \alpha_0 + \alpha_1 Y_t + \alpha_2 IFD_T + \alpha_3 CPI_t + \alpha_4 GE_t + \in_t$$

VARIABLES OF THE STUDY:

Income inequality and poverty were used as dependent variables in the study. Income inequality measure by GINI coefficient and Poverty measure by Poverty ($1 per day). The independent variables include the Islamic financial development , which could be measured by using the total Islamic finance in (Murābahah, Commodity Murābahah / Tawwaruq, Salam Istisnā`, Ijārah / Ijārah Muntahia Bittamlīk, Muḍārabah, Mushārakah, Diminishing Mushārakah, Wakālah and Qarḍ Hassan). Other control variables shall be employed such as GDP (GDP CONSTANT 2015 US$), inflation (CONSUMER PRICE INDEX), education (Government expenditure on education).

ECONOMETRIC TECHNIQUE:

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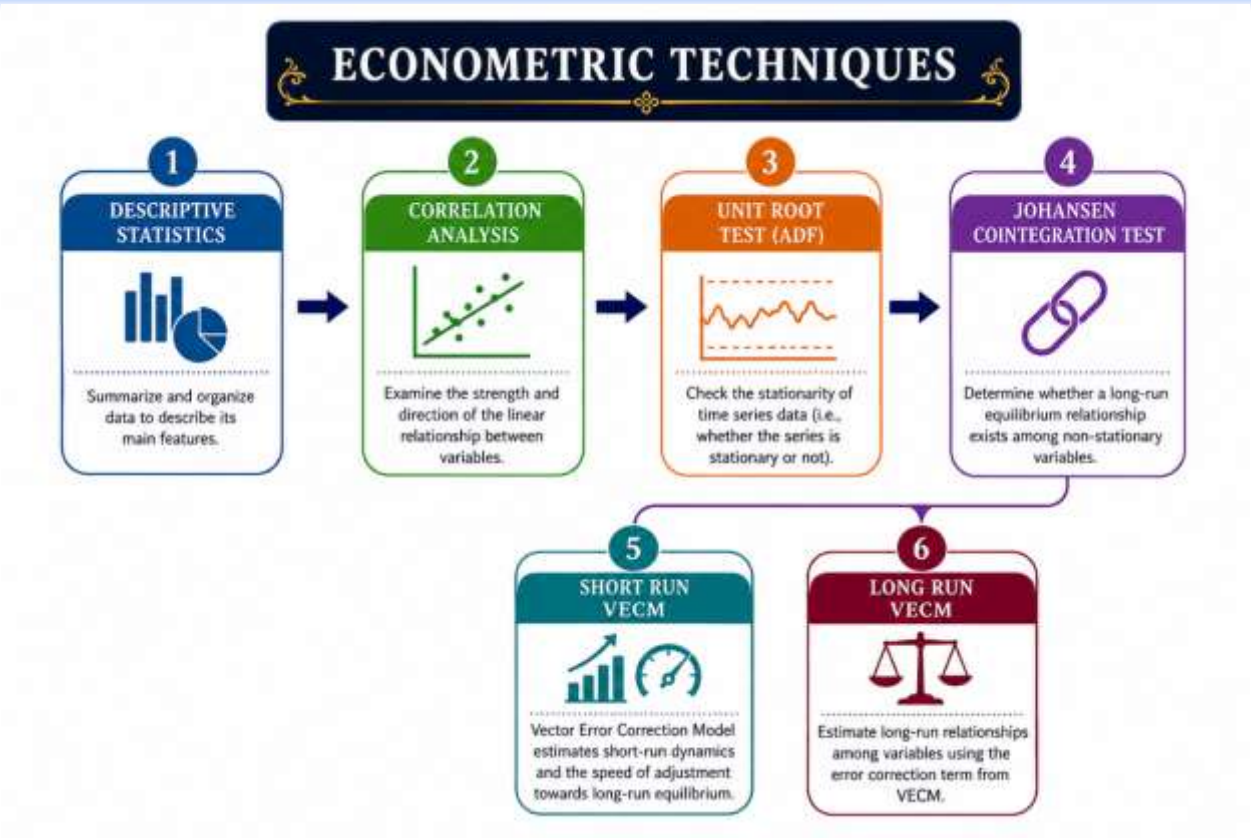

Data Analysis and Results:

This section discusses the empirical analysis and findings of the study which was conducted to examine the impact of Islamic financial development on income inequality and poverty in Pakistan. It explains the statistical and econometric techniques used to analyze the relationship among the variables. The section starts with descriptive statistics and correlation analysis, then unit root tests to study the stationarity of data. Then, to study the long-term and short-term relationship between Islamic financial development, poverty, and income inequality, the ARDL Bounds Testing approach is used. Also, diagnostic and stability tests are performed to assure the reliability and validity of the estimated model. The findings of this section offer empirical evidence on the ability of Islamic financial development to alleviate poverty and income inequality in Pakistan.

Table 1: DESCRIPTIVE STATISTICS TABLE:

	GINI	POV	IFD	CPI	GE	Y
Mean	3.435000	23.01836	13.55290	5.271223	2.185794	26.56968
Median	3.420000	21.88125	13.73259	5.155491	2.209630	26.59959
Maximum	3.530000	29.50000	14.64142	5.957918	2.668040	26.74117
Minimum	3.390000	20.50000	12.27576	4.884274	1.687461	26.34527

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Std. Dev.	0.041769	2.915400	0.763552	0.342462	0.272875	0.129412
Skewness	0.924106	1.286745	-0.330894	0.832539	0.085023	-0.352348
Kurtosis	2.919905	3.298882	2.005608	2.411375	2.350360	1.846284
Observations	48	48	48	48	48	48

The mean shows the average value of the variable ,for example, the Gini has the mean of 3.435 whereas, the poverty has the mean of 23.01836. Then we have in the next row median, which shows the middle value, and in the data if the mean equals to the median then the data is roughly symmetrical., for example in the data we can see that the mean of genie and the median of genie are roughly close. Then we have the highest and lowest observe values which are the maximum and minimum values in all of the variables. The standard deviation shows how much the values deviate from the mean. If the standard deviation is small then it means that the values are clustered tightly, whereas, the large value of S.D. means that they are spread out. Skewness shows the symmetry of distribution. It can be of three types: positively skewed, negatively skewed, or symmetric. Symmetric is when the values are near to zero. Positively skewed are those values which are greater than zero and their tail is on the right side. Negatively skewed are those which has the tail on the left and their values are lower. Kurtosis shows the tailedness of distribution. It can be be either Mesokurtic, or platykurtic, or leptokurtic. Meso is normal whose value is equal to 3. Platykurtic are lighter tails, having value greater than 3. In addition, lepto is when the values are below three. In the table, we can see that all values are less than three except for the poverty index having value greater than 3 so, all values are leptokurtic and only poverty is platykurtic. Jarque-Bera test and probability test whether the data is normally distributed or not. If the probability value is less than 0.05 or 5% then we reject the data or we reject normality. From the table we see that the probability of Gini is less than 0.05 so the data of Gini is not normal, same goes for CPI, the data of inflation is also not normal but all other data values of all the variables are normal. Sum is the total number of observations whereas, sum of squared deviations are used for the variances. Overall, the number of observations are 48.

Table 2: Correlation Matrix

	GINI	POV	IDF	CPI	GE	Y
GINI	1.00	-0.33	0.04	-0.21	0.44	0.02
POV	-0.33	1.00	-0.86	-0.60	0.34	-0.87
IDF	0.04	0.86	1.00	0.90	-0.56	0.98
CPI	-0.21	-0.60	0.90	1.00	-0.68	0.89
GE	0.44	0.34	-0.56	-0.68	1.00	-0.60
Y	0.02	-0.87	0.98	0.89	-0.60	1.00

The Correlation Matrix shows the strength and direction of linear relationships between the variables. Its value ranges from -1 to + 1. +1 shows perfect positive correlation whereas, negative one shows the perfect negative correlation, and if the value is zero then there is no linear relationship among the variables. For example, a

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very strong positive correlation is seen, from the table, in IDF and Y, CPI and Y shows positive correlation. IFD and CPI also shows the positive correlation, whereas, poverty and income, poverty and IFD shares strong negative correlation. Government expenditure and income shows moderate negative correlation, whereas, Gini and income shows no correlation at all.

Table 3: Unit Root Test:

Unit	Level	First difference	Results
GINI	**-1.83 (0.3603)**	**-6.038 (0.0001)**	**I(1)**
POV	**-2.38(0.151)**	**-7.707(0.0001)**	**I(1)**
IFD	**-1.20(0.663)**	**-8.081(0.0001)**	**I(1)**
CPI	**0.71(0.991)**	**-6.708(0.0001)**	**I(1)**
GE	**-1.05(0.725)**	**-6.661(0.0001)**	**I(1)**

The results from the panel unit root test applied to the stationarity properties of the variables, such as GINI, POV, IFD, CPI and GE are shown in the table 3. At the level form, all variables have probability values greater than 0.05 which means that the null hypothesis of a unit root cannot be rejected. This means that the variables are non-stationary at level. For instance, the test statistic of GINI is -1.83, and the probability value is 0.3603, and the test statistic of POV is -2.38, and the probability value is 0.151, which indicate that the original series has unit roots. For the same reason of high p-values, IFD, CPI and GE are also non-stationary at level.

All variables are now highly significant with a p value of 0.0001, which is less than the 5% significance level after taking the first difference. The test statistics also become strongly negative, such as GINI (-6.038), POV (-7.707), IFD (-8.081), CPI (-6.708), and GE (-6.661). Thus, the null hypothesis of a unit root is rejected at the first difference, implying that all variables are stationary at the first difference. Therefore all variables are integrated once (I(1)). This result shows that the data series are appropriate for subsequent long-term econometric approaches like johenson co-integration and VECM approaches

Table 4: JOHANSON CO INTEGATION FOR MODEL 1:

Unrestricted Cointegration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.658041	126.1084	79.34145	0.0000
At most 1 *	0.630054	79.96667	55.24578	0.0001
At most 2 *	0.374091	37.20751	35.01090	0.0286
At most 3	0.215556	17.05987	18.39771	0.0762
At most 4 *	0.142695	6.620354	3.841465	0.0101

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

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Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.658041	46.14174	37.16359	0.0036
At most 1 *	0.630054	42.75915	30.81507	0.0011
At most 2	0.374091	20.14764	24.25202	0.1593
At most 3	0.215556	10.43952	17.14769	0.3580
At most 4 *	0.142695	6.620354	3.841465	0.0101

The Johansen Cointegration Tests results for the Johansen model 1 with the Trace Statistic and Maximum Eigenvalue methods, used to check if there is a long-run relationship between the variables are given in Table 4. The results of the Trace test indicate that the null hypotheses of the absence of cointegration, at most one cointegrating equation and at most two cointegrating equations are rejected due to the higher value of the trace statistics compared to its critical value and the probability values less than 0.05. But the null hypothesis at "At most 3" can not be rejected, which means that there are at least three cointegrating equations. Likewise, the null hypothesis that there is no cointegration, and at most one cointegrating equation is rejected, and the null hypothesis that at most 2 cointegrating equations cannot be rejected because the p-value is insignificant. Overall, both tests confirm the presence of cointegration among the variables in the model, suggesting that a stable LR relationship exists among the variables for Model 1, and hence the use of LR estimation methods like VECM, FMOLS or DOLS can be used for further analysis.

Table 5: Long run Results (VECM) Poverty Dependent Variable:

Variable	**Coefficient**	**Std. Error**	**t-Statistic**
IFD	-17.95370	3.42658	-5.23955
GE	-5.747962	1.77220	-3.24341
CPI	12.52537	2.68189	4.67035
Y	-60.26147	18.3364	-3.28644

The results show that Islamic Finance financial development (IFD) has a negative and statistically significant relationship with poverty, as indicated by the coefficient value of -17.95370 and t-statistic of -5.23955. In the long run, the Islamic financial development can reduce poverty because it can improve the access to Sharia compliant finances and increase the risk sharing. The financial inclusion theory fits here as well, as it says that when the poor households or the small firms have access to finances, then they invest more and earn more, which moves them out of the circle of poverty, which they had been in for a long period. Rashid and Intartaglia (2017) found in their study that financial development has a significant role in reducing absolute poverty. Majid et al. (2019) also found that financial development and poverty had a positive relationship with each other.

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The table clearly shows that Government expenditure has a negative impact on poverty. Government expenditure can reduce the poverty when it is directed towards education Health social protection and infrastructure the redistribution Theory explains that public spending can transfer the resources to the poorer groups and improve their living standards, which lowers the poverty over time. Mehmood and Sadiq (2010); Asghar and Hussain (2012); Yahaya (2019), all estimated that government spending has significantly negative effects on poverty. This means that and increase in the government expenditure will lead to reduce the poverty, thus, the poor people will become well-off because the government spends on development and welfare projects and programs, which reduces poverty.

Economic growth (Y) has a negative and significant relationship with poverty, with a coefficient value of -60.26147 and a t-statistic of -3.28644. This result supports economic theory, which states that higher economic growth increases income, employment opportunities, and overall economic activity, leading to improvements in living standards. As the economy grows, governments collect more revenue and can spend more on social development programs, infrastructure, and poverty reduction initiatives. Economic growth also stimulates investment and production activities, which create jobs and increase household income, thereby reducing poverty in the long run. Chaudry and Wimer (2016); Laabas and Limam (2004) show in their study that an increase and income has significantly negative impact on poverty. This means that if the income increases, then the poor households will rise from poverty, as they will have access to more basic needs than before.

Consumer price index CPI has a positive impact on poverty. This means that arise and CPI can increase poverty because inflation causes the real purchasing power of the consumer, especially the poor household, to decrease. As per the purchasing power theory, when prices rise faster than income, poor people can buy less, so more of them fall into the poverty trap. Chani et al,. (2011) stated that inflation has a positive impact on poverty. Powers (1995) also found that inflation has a large positive relationship with the consumption poverty rate. The results are highly significant.

Table 6: Short Run Results (VECM) Poverty Dependent Variable:

Variable	Coefficient	Std. Error	t-Statistic
D(IFD)	-1.885397	1.070769	-1.760788
D(GE)	-0.938161	0.666929	-1.406687
D(CPI)	7.049916	0.948621	7.431755
D(Y)	-26.49125	5.902330	-4.488269
CointEq1	-0.186091	0.05944	-3.13062

Table 6 shows, for poverty as the dependent variable, the short run dynamics of the Vector Error Correction Model (VECM). The differenced Islamic financial development (D(IFD)) is negatively related to poverty, but statistically weak, indicating that short-term increase in Islamic financial development has a negative but slight, and not strongly significant impact on poverty. This means that financial inclusion through Islamic Finance is a gradual process of bringing effectiveness to

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poverty reduction once financial access and financial institutional reach has been achieved. In their studies, Rashid and Intartaglia (2017);Agustina et al,.2022 also discovered that financial development has a significant impact in lowering the absolute level of poverty, as similarly determined in my short run study. However, due to the lesser t-statistic value than 2 leads to insignificant results of IFD.

CPI's results indicate that in the short-run, Inflation positively affects poverty. In short-run, inflation leads to a reduction in the real purchasing power of the poor consumer, thus negatively affecting their consumption and leading to an increase in poverty. I got similar findings from my study as did Talukdar (2012) and Yolanda (2017) in their study where they found that as the inflation increases, the poverty increases. Contrary to the above, Rizki and Solihati (2022) determined that the higher the level of CPI, the lower the level of poverty.

There is a negative and statistically significant relationship between economic growth and poverty, meaning that an economic growth increase in the short run is statistically significant in reducing poverty. This reinforces the notion that growth can generate jobs, raise incomes and generate economic activity and hence increase the living standards in the short run. Agbeni et al., (2025) & Mardianto et al., (2025) results suggested that economic growth has reduce the poverty.

The error correction term is negative and statistically significant which validates the existence of stable long run equilibrium relationship between variables. This coefficient of -0.186091 indicates that each period, some 18.6% of any short run poverty shock is offset, so the system is slowly moving toward long run equilibrium once a shock occurs.

Table 7:JOHANSON COINTERATION FOR MODEL 2:
Unrestricted Co-integration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.862022	159.3172	76.97277	0.0000
At most 1 *	0.507555	72.16805	54.07904	0.0006
At most 2 *	0.356856	40.99963	35.19275	0.0106
At most 3 *	0.260398	21.57861	20.26184	0.0328
At most 4	0.172032	8.306338	9.164546	0.0726

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.862022	87.14910	34.80587	0.0000
At most 1 *	0.507555	31.16843	28.58808	0.0229
At most 2	0.356856	19.42102	22.29962	0.1203

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At most 3	0.260398	13.27227	15.89210	0.1236
At most 4	0.172032	8.306338	9.164546	0.0726

Table 7 shows Johansen Co-integration Test results for the Johansen Model 2, with both Trace and Maximum Eigenvalue methods used to identify the long-run relationship between the variables. The Trace test shows that the null hypothesis of absence of co-integration is strongly rejected (Trace statistic is 76.97277 with probability 0.0000), and the hypotheses of at most 1, at most 2 and at most 3 co-integrating equations are also strongly rejected, which means that there are several co-integrating equations, but only at "at most 4" the result is insignificant. Similarly, the Maximum Eigen value test also rejects the null hypothesis of no co-integration and accepts the alternative at 5% level at most 1 cointegration equation, with test statistics exceeding the critical values, and significant p-values. Overall, the two tests provide consistent evidence to support a stable relationship in long run between the variables of Model 2, thus demonstrating that variables change together in the long run and can be analyzed using the long run estimation technique like VECM.

Table 8. Long run Results (VECM) GINI Dependent Variable

Variable	Coefficient	Std. Error	t-Statistic
IFD	-1.720360	0.37448	-4.59395
GE	-0.590257	0.19586	-3.01365
CPI	0.675955	0.29566	2.28627
Y	- 1.531705	0.40107	-3.81909

The long-run VECM results for the country of Pakistan are reported in Table 8 for Islamisation of financial development, government expenditure, inflation and economic growth on income inequality. The results show that Islamic financial development (IFD) negatively impacts inequality with a coefficient of -1.720360 and a t-statistic of -4.59395 which is statistically significant. Thus, the growth of Islamic finance in Pakistan is contributing to the alleviation of income inequality as it enhances financial inclusion, extends access to sharia-compliant finance, and enables small enterprises and the masses with lower income. This aligns with findings of other studies, like Beck et al. (2013), which suggest that inequality is lowered if poorer populations can engage in economic activities in an inclusive financial system.
Government expenditure (GE) is also negatively and significantly related to inequality, -0.590257 with t statistic being -3.01365. From an economic point of view it means that good governance in Pakistan increases the quality of services, increases the capacity of institutions, and reduces inequality in the distribution of public services, which in turn reduces income inequalities. Good governance improves transparency and minimizes leakages of public programs, particularly in favor of lower income groups. Anderson et al., (2017) & Sidek (2021) results suggested that governmental expenditure has reduce the income inequality.

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The coefficient of the variable "inflation (CPI)" is 0.675955 and the t-value is 2.28627, indicating positive and significant effect on inequality. This shows that inflation has a negative impact on income inequality since it erodes the purchasing power of wage earners and the groups with fixed incomes, and enriches those who have assets and can raise prices more rapidly. Inflation, especially in developing countries like Pakistan, has a more adverse effect on the poor as a result of low wage indexation and lack of robust social protection measures. The results of Göcen (2024) study indicated that inflation is positively related to income inequality.

The relationship between economic growth (Y) and inequality is negative and significant (-1.531705, -3.81909) however. This indicates that the country's economic growth is less exclusive and it has helped in reducing inequality by creation of jobs, expansion of incomes and poverty alleviation impacts. The discovery lends credence to the notion that growth, in the presence of employment creation and structural transformation, can lead to better income distribution, especially in developing countries where employment is a major concern of growth and where labor-intensive industries are important for the generation of employment. According to Kuznets (2019) the level of income inequality has been decreasing due to economic growth.

Table 9: Short Run Results (VECM) GINI Dependent Variable

Variable	Coefficient	Std. Error	t-Statistic
D(IFD)	-0.179411	0.00728	-24.6200
D(GE)	-0.123360	0.03538	-3.48706
D(CPI)	0.074500	0.01745	4.26721
D(Y)	-0.144064	0.00347	-41.5073
CointEq1	-0.252805	0.13147	-1.92291

Table 9 presents the short-run VECM results of regression of Pakistan with GINI as dependent variable, which indicates the effects of Islamic financial development, good governance, inflation and economic growth on Gini index in the short run. The results show that D(IFD) is highly significantly and negatively correlated with inequality. It indicates the role of SR Islamic Finance in decreasing the inequality of the society of Pakistan by increasing the access to credit, providing support to microfinance and increasing financial inclusion among low-income groups. In this regard, it is consistent with Demirgüç-Kunt and Levine (2009), who believe that financial development can help lower inequality if it is not exclusively to the benefit of the elites.

In addition, D(GE) is negatively and significantly related with inequality, such that a short-term increase in the effectiveness of government decreases inequality. With reference to economic benefits, good governance can lead to improved quality of public service, less corruption and more efficient use of resources. This is reflected in the work of Acemoglu and Robinson (2012), who argue that the importance of effective institutions is to lower inequality through boosting inclusive economic participation and limit elite capture.

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The inflation (D(CPI)) has a positive and statistically significant effect on inequality, which suggests that income inequality in Pakistan is positively related with inflation in the short run. Inflation puts people with lower incomes at a disadvantage since real income and prices are lowered while higher-income groups can shield themselves through assets and price changes. A similar pattern is observed in the developing countries by Easterly and Fischer (2001), who find that inflation disproportionately affects the poor and thus drives up inequality in these countries.

Economic Growth has a strong negative and significant relationship with inequality, indicating that inequality in Pakistan gets affected negatively from short run economic growth. Growth creates job opportunities, boosts household incomes, and enhances the labor market, particularly in countries where the labor market is dominated by labor-intensive sectors and the economy is developing. It corroborates Kuznets (1955), who argues that growth, if it is broad-based and employment generating, can help to lessen inequality.

Finally, the error correction term (CointEq1) is negative, a sign of movements towards the long run equilibrium, but its relative small size means slow movements towards the LR equilibrium. The coefficient is an approximation that suggests that the system adjusts moderately fast, as around 25% of disequilibrium is corrected every period.

Conclusion

This study analyzed the effect of Islamic financial development on income inequality and poverty in Pakistan, while taking the data from 2013 to 2024 on a quarterly basis. In analyzing the relationship between the variables, various econometric techniques were utilized such as descriptive statistics, correlation analysis, Johansen cointegration test, unit root test and the Vector Error Correction Model (VECM). The empirical results supported the existence of a significant LR relationship between Islamic financial development, poverty and income inequality in Pakistan.

The findings show that Islamic financial development is a significant factor in decreasing poverty and income inequality along with financial inclusion, entrepreneurship and provision of Shariah compliant financial services to various groups of society. The study also concluded that inflation has made poverty and inequality worse because it has left people less able to afford to buy the things they need and made things more expensive for them, particularly the poor. Economic growth, on the other hand, has been instrumental in combating poverty and income inequality by creating jobs, enhancing avenues for income generation, and boosting economic activity.

Moreover, the estimates for the short-run and long-run VECM showed that Islamic financial institutions have a positive impact on the socio-economic welfare and equitable income distribution in Pakistan. The results of the diagnostic and stability tests validated a statistical model, meaning it was found to be reliable and stable in the period analyzed. Based on the above discussion, it is concluded that if Islamic financial development is supported with well-designed policies, well-established institutional arrangements and proper implementation of Islamic financial social tools

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like Waqf, Zakat and Islamic microfinance, then Islamic financial development can be an effective instrument for poverty alleviation and reduction of income inequality in Pakistan. The study suggests a further development of Islamic finance sector to foster sustainable and inclusive economic growth in Pakistan through the initiative of the policy makers and State Bank of Pakistan.

Recommendation

The recommendations based on the results are made for Pakistan.

To conclude, the results suggest that development of Islamic finance in Pakistan not only lowers the level of poverty and income inequality but should also be promoted by extending Islamic banking services and Islamic microfinance institutions in the rural and underserved areas of Pakistan by government and State Bank of Pakistan.

Islamic social finance mechanisms like Zakat, Waqf, Sadaqah and Qard-ul-Hasan, need to be optimally utilized and included in national poverty alleviation measures to benefit the poor and vulnerable.

Policymakers need to enhance the regulatory and institutional framework of Islamic finance to increase transparency, efficiency and trust in Islamic financial institutions.

Policies designed to address inflation and price stability should be put in place by the policymakers to cushion the impact of inflation on the poor and reduce poverty levels, as inflation raises poverty and income inequality levels.

Economic growth is a prerequisite for poverty reduction and income inequality, therefore the government should encourage inclusive economic growth through employment creation, encouragement of small businesses and more investment in productive sectors by utilizing Islamic financing methods.

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