

Islamic finance and its role in funding startups an analytical study of financing mechanisms and their role in supporting entrepreneurship

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Abstract:

This research aims to obtain alternative financing sources provided by Islamic banking products that can be utilized to finance startups with one of the current products in the form of debt-and-equity. Focusing on startups has become an absolute necessity due to their importance in economic growth and their crucial role as a breeding ground for new generations of entrepreneurs and businessmen. these enterprises play also a significant role in increasing the rate of economic activity and combating unemployment. Therefore, this research concludes that Islamic finance institutions must be supported with mechanisms that serve this type of startup, given the advantages they offer to the projects and to the economy in general. Moreover, Islamic institutions finance these ventures as part of their social responsibility, which stems from their inherent developmental role.

Keywords: Islamic finance, Islamic finance mechanisms, economic growth, startups

Jel Classification Codes : G24.G32.

1. Introduction :

Startups are considered one of the most prominent forms of entrepreneurship and occupy a significant space in national economies. Their establishment and development are among the most critical factors that improve a country's economic and social conditions. Startups require funding to manage growth plans, research and development efforts, and innovation. Given their limited financial resources, they often seek the help of financial institutions to cover these shortcomings. However, these institutions are often characterized by stringent service requirements due to insufficient guarantees. Therefore, turning to alternative financing methods that better suit the nature of these startups has become urgently important. Among the most vital of these methods is financing using Islamic formulas, which is based on commitment to the principles of Islamic Sharia and the funding of development projects that benefit both their owners and society.

Based on the foregoing, the study attempts to answer the following problem :

To what extent do Islamic products contribute to the financing of startups?

To answer this main question, we will address three main sections:

- Islamic finance operations
- Startups and their economic role.
- The role of Islamic financing mechanisms in activating startups.

Section One: Islamic Finance Operations

1. The Conceptual Framework of Islamic Finance

1.1 Definitions of Islamic Finance:

- Islamic finance, in its broad sense, is the provision of tangible or monetary wealth by its owner to another person who manages and disposes of it, in exchange for a return permitted by Sharia rulings. (Munther Qahf, 1991, p. 12)
- Islamic finance refers to the various models and structures that involve providing financial and economic resources for any financial or economic activity in accordance with the rules of Sharia law. (Dr. Hossam El-Din Ibrahim, 2021, p. 67)
- In its broadest sense, Islamic finance is the provision of tangible or monetary wealth, whether the financier intends to profit, donate, or grant usufruct. Meanwhile, financial transactions must adhere to the Sharia principles. (Ayman Saleh Jamal Qasim, 2022, p. 9)

All previous definitions have been synthesized in one that combines all formulations: (Muhammad Abdul Hamid Muhammad Farhan, p. 31)

"Islamic finance is the transfer of tangible or monetary wealth, either as an obligation, donation, cooperation, or profit, from its owner to another person who manages and disposes of it in return for a moral or material return permitted by Sharia rulings."

Through these definitions, it is evident that Islamic finance exhibits distinct characteristics that differentiate it from conventional finance.

1.2 Characteristics of Islamic Finance:

The most significant include: (Mahdid Hamid, 2019, p. 30)

- Islamic finance adheres to the provisions of Islamic Sharia in all its operations and transactions.
- The functions and instruments used by Islamic financial institutions differ fundamentally in their core nature from those of conventional banks, which follow Western banking models in their transactions.

1.3 Objectives of Islamic Finance:

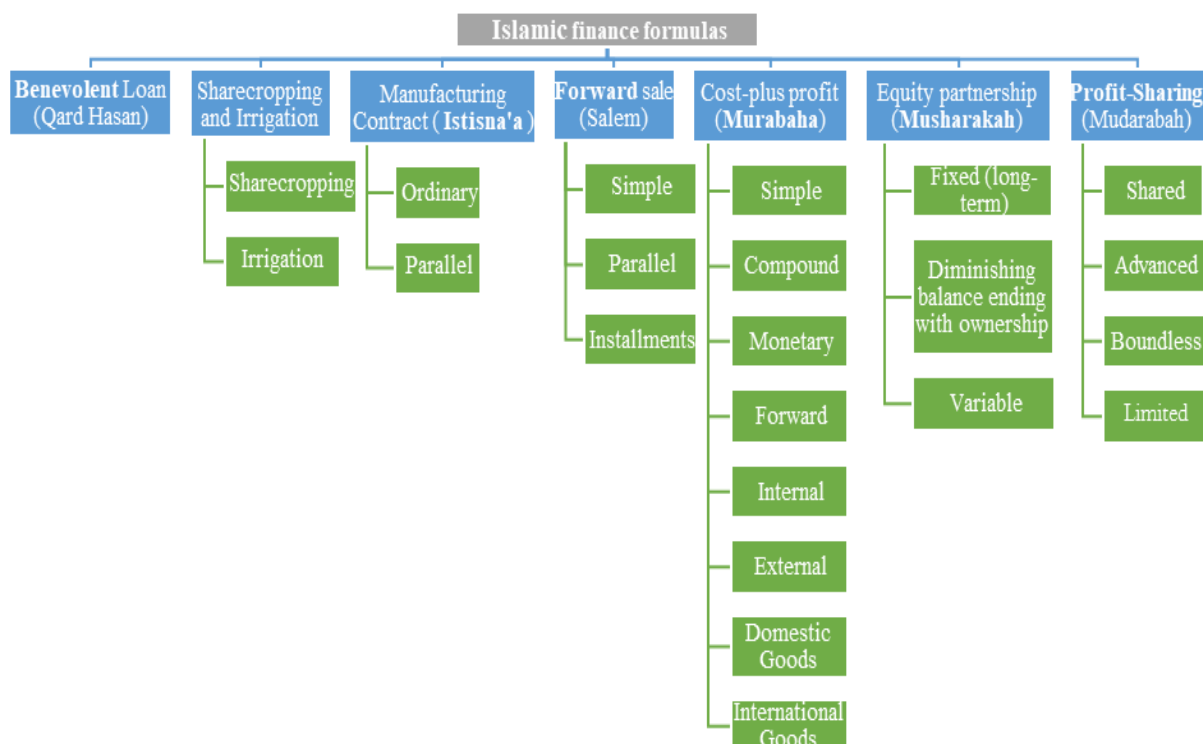
The objectives of Islamic finance are summarized in the following points: (Samir, 2015, p. 47)

- Collecting the maximum possible amount of financial resources by pooling savings from individuals and various entities in society, which can be benefited from in financing economic activities.
- Generating reasonable profits from operations and activities for both savers and clients who utilize the financial resources provided by Islamic finance.
- Expanding economic activities to contribute to economic development and growth, in accordance with Islamic Sharia principles, by using methods and instruments that align with those principles.
- Providing social services that contribute to serving and developing society, and meeting social needs by financing activities that achieve public social benefit.
- Working towards achieving a strong financial position for the Islamic bank and enabling it to increase its market share. It can be achieved by enhancing the bank's ability to attract and utilize savings, expand its services, and provide greater benefits to shareholders, customers, society, and the economy as a whole.

2. Islamic Financing Instruments

The financing tools and instruments used by Islamic banks represent a crucial part of Islamic banking operations. These instruments have provided a significant capacity to attract savings for investment purposes, surpassing conventional banks. They have succeeded in attracting the savings of small and medium-income earners and directing them toward effective investment. Islamic finance takes many forms; each instrument consists of a portfolio of different financing contracts, including, See Figure 1 below:

Figure 1: Islamic Financing Portfolio



Source: Prepared and adapted by the researche

2.1 Financing via Profit-Sharing Partnership (Mudarabah):

It is defined as a contract between two parties, one of whom provides capital and the other contributes his effort and management. Each party's share is determined as a pre-defined percentage of the profit. Banking Profit-Sharing Partnership is an agreement between one or more clients and the Islamic bank. Profits are distributed, according to the contracts, between them, and the bank bears the resulting losses unless the manager violates the terms of the contract. (Muhammad Ali Shalhoub, 2007, p 432)

2.2 Financing via Partnership (Musharakah):

This is one of the fundamental Sharia-compliant instruments of investment in Islam that achieves many advantages. It is an effective means of eliminating usurious transactions. The financing via the Partnership formula links labor and capital in the economic development field. (Dr. Amira Abdel Latif Mashhour, 1991, p289)

2.3 Financing via Cost-Plus Financing (Murabaha):

It is a financing tool used to finance internal and foreign trade operations. It can be applied to various activities and sectors, whether for individuals, private companies and institutions, or government entities. It is a sale with a profit margin on the initial price, It is considered a type of "Trust Sale". (Dr. Qadi Abdel Majid, 2002, p 108).

2.4 Financing via Forward Sale:

This is the sale of a commodity described in detail for a price paid in advance. The price is paid at the time of the contract, and the commodity is delivered after a specified deadline. It is a contract between two parties where the first party pays the price upon contracting, and the second party delivers the commodity at a later date as agreed. (Dr. Alaa Mustafa Abu Ajila et al., 2022, p. 150)

2.5 Financing via Manufacturing Contract:

This is a financing tool that does not require an upfront payment; it may be delayed in whole or in part. Through financing via a manufacturing contract, buildings can be constructed on land owned by the client under a contract. Some consider this contract equivalent to a "House Delivery" in modern contracts. This financing instrument applies to goods and commodities where manufacturing is involved at any stage of production, opening wide fields for Islamic banks to finance public projects and major societal interests to advance the Islamic economy. (Dr. Muhammad Mahmoud Al-Makawi, 2015, p. 107)

2.6 Sharecropping and Irrigation :

- **Sharecropping:** It involves the owner giving land to someone to cultivate it or work on. As a consequence, they share the produce. The Islamic financing bank for sharecropping is a type of partnership wherein the other partner provides the labor on the land, and each receives a pre-agreed percentage. (Dr. Salem Salal Rahi Al-Hasnawi, Syria - Damascus, 2019, p. 150).
- **Irrigation Partnership:** This is a financing tool used by Islamic banks to finance drinking water projects, irrigation schemes, and land reclamation for cultivation and development using modern technology. The banks then manage these water and irrigation projects based on the principle of commercial profitability. (Dr. Salem Salal Rahi Al-Hasnawi, Syria - Damascus, 2019, p. 151).

2.7 The Interest-Free Loan:

This is one of the most prominent forms of cooperative financing based on granting the borrower the right to benefit from the money on the condition that they return an equivalent amount. This form is unique to Islamic law in financing the needy and the poor, in accordance with Allah Almighty's saying: "Who is he that will lend to Allah a goodly loan so that He may multiply it to him many times?" Surah Al-Baqarah, verse 245. (Muhammad Abdul Hamid Muhammad Farhan, same reference, p. 47)

3. The development of Islamic finance formulas in Algeria during the period (2020-2024):

Following the issuance of Regulation 20-02 dated March 15, 2020, which allowed Islamic banks to establish windows in public banks, the initiative aimed to attract a larger number of customers and track the development of Islamic finance products through private banks that

provide Islamic financing tools compliant with Sharia rulings, The table below illustrates the volume of Islamic finance deposits.

3.1 Volume of Islamic Finance Deposits:

Table No. (01): Volume of Islamic Finance Deposits (Unit: Billion Dinars)

Nature of deposits	2020	2021	2022	2023	2024
Deposit accounts	163.0	212.0	254.3	421.7	521.7
Deposits in investment accounts	177.0	231.9	299.5	256.5	271.8
Total	340.0	443.9	553.7	678.2	793.5

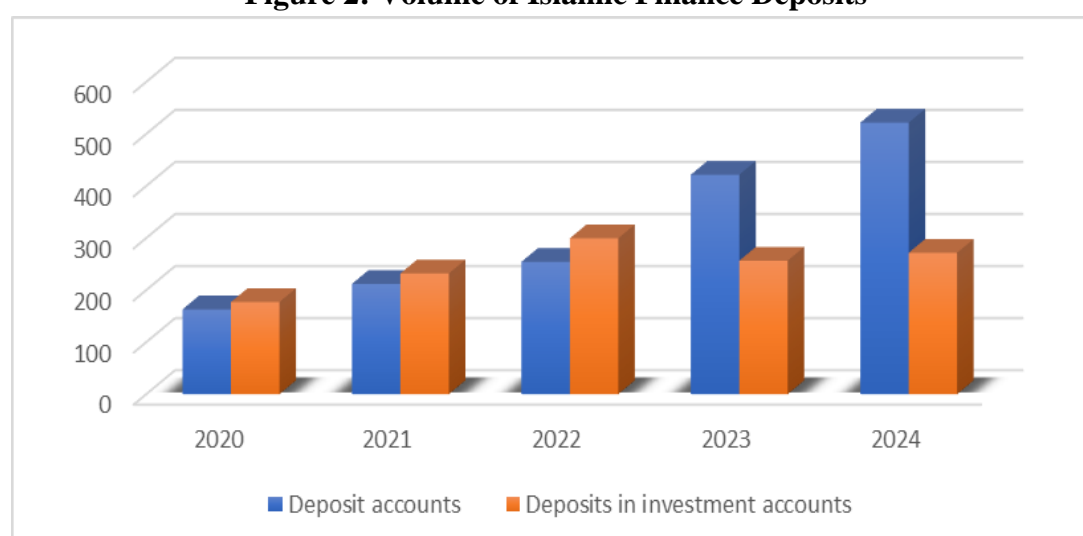
Source: - Bank of Algeria, Annual Report 2023, Economic and Monetary Developments, June 2024

Bank of Algeria, Annual Report 2024, Economic and Monetary Developments, June 2025

We observe from the table above that the volume of deposits related to Islamic finance recorded a significant increase in 2024 compared to the previous year, reaching 115.3 billion dinars, equivalent to 17%. However, this growth is lower compared to previous years, which recorded increases of 24.58% and 22.42%. This decline in the growth rate is attributed to a decrease in the volume of deposits in investment accounts, which recorded a growth of 29.24% in 2022 (compared to 2021), followed by a decline of 14.41% (equivalent to 43.2 billion dinars) in 2023. This decline was subsequently reversed in 2024, as deposits rose by 15.3 billion dinars, representing a growth rate of 5.75%.

The previous overall increase in financing operations is due to the opening of Islamic windows in convention) all banks, which served as a support to private Islamic banks. Therefore, it is necessary to determine the respective shares of each in the following section. For further clarification, see the figure below.

Figure 2: Volume of Islamic Finance Deposits



Source: Prepared and adapted by the researcher.

3.2 Share of Public and Private Banks in Islamic Finance Deposits:

Table No. (02): Banks' Share of Deposits (%)

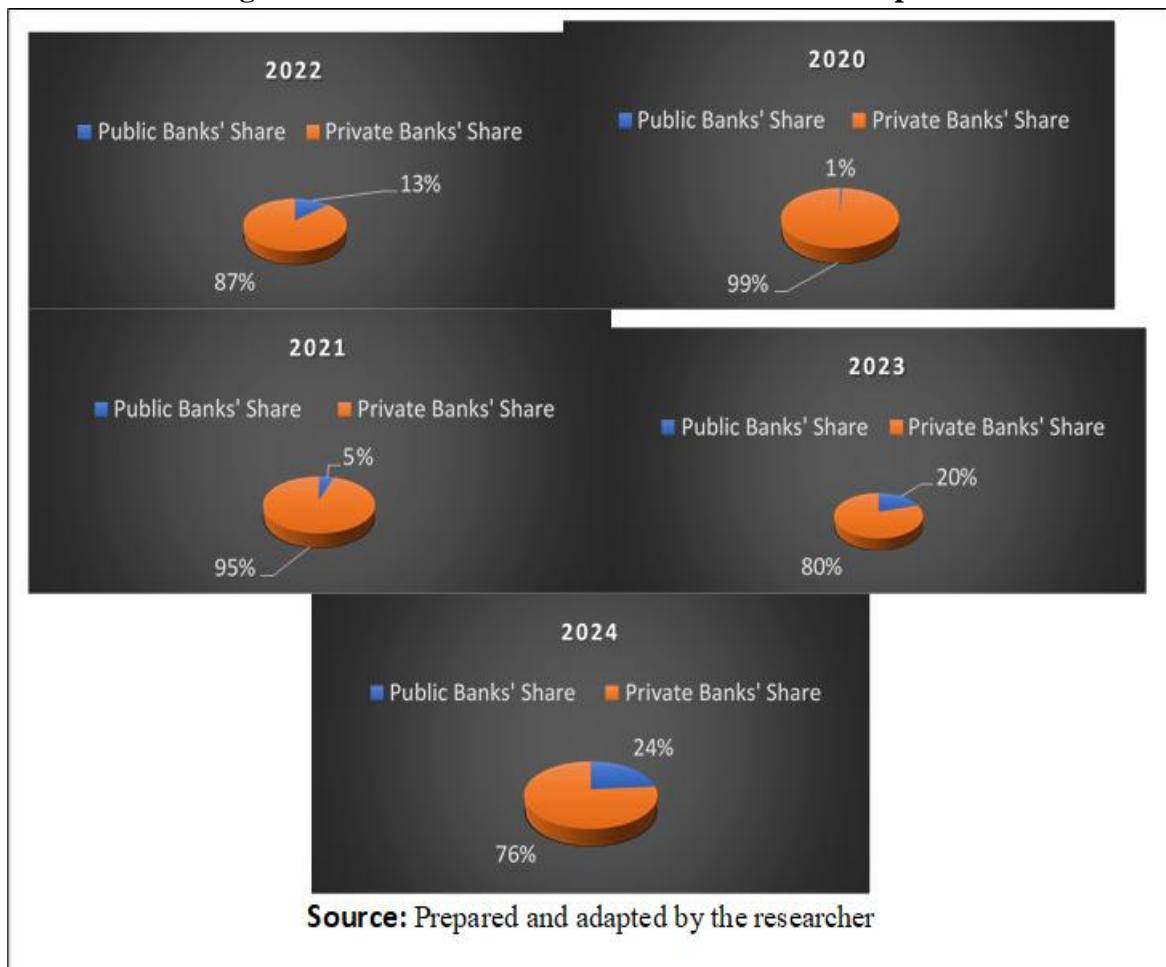
Statement	2020	2021	2022	2023	2024
Public Banks' Share	0.81	5.16	13.10	20	23,74
Private Banks' Share	99.19	94.84	86.90	79.79	76.26

Source: - Bank of Algeria, Annual Report 2023, Economic and Monetary Developments, June 2024

- Bank of Algeria, Annual Report 2024, Economic and Monetary Developments, June 2025

We note from the table above that private banks held the largest share of deposits over the past five years. However, a gradual decrease in their market share was observed, with change rates ranging from 3% to 7%. This is attributed to the opening of Islamic banking windows within public banks, which recorded corresponding gradual growth from 3% to 7%. Refer to the figure below for further details.

Figure 3: Share of Public and Private Banks in Deposits



3.3 Islamic Finance Product Portfolio

The Islamic finance products offered by both public and private banks have also witnessed significant development in terms of value from year to year, The following table illustrates this evolution:

Table 3: List of Islamic Finance Products (Unit: Billion Dinars)

Islamic Finance Products	2020	2021	2022	2023	2024
Cost-plus financing (Murabaha)	132.3	130.7	129.7	139.5	173.6
Equity partnership (Musharakah)	1.2	1.1	2.0	4.2	5.4
Profit-Sharing (Mudarabah)	4.9	6.0	7.6	8.3	25.7
Leasing (Ijarah)	82.7	83.9	86.5	100.4	121.7
Forward sale for immediate payment (Salam)	74.7	133.1	153.9	187.7	174.2
Manufacturing Contract (Istisna'a)	6.6	11.1	0.9	18.5	30.3
Benevolent Loan (Qard Hasan)			0.0002	0.1	1.4
Total	302.3	365.9	380.60002	458.5	532.3

Source: - Bank of Algeria, Annual Report 2023, Economic and Monetary Developments, June 2024

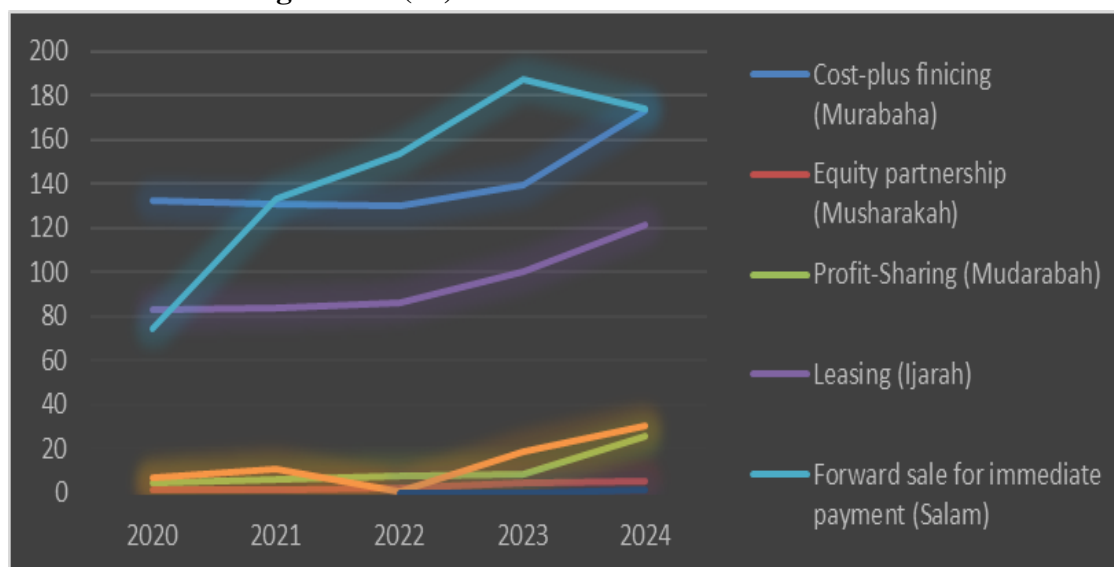
-Bank of Algeria, Annual Report 2024, Economic and Monetary Developments, June 2025

As shown in the table above, there is a diverse portfolio of Islamic financing sources. However, according to product type, financing through the "Forward sale for immediate payment (Salam)" mechanism remained in the first rank in terms of volume throughout the study period, accounting for 32.73% to 45% of total financing. Although this formula consistently held the top position with a relative year-on-year increase, it declined in 2024 by 13.5 billion DZD.

Financing through the "Cost-plus financing (Murabaha)" method ranks second, representing between 30% and 35% of total financing. This is evidenced by a notable increase, particularly between 2023 and 2024, reaching 34.1 billion DZD, or 24.4%. The third largest type of financing is "Leasing (Ijarah)," which accounted for approximately 22.87% of total financing over the last five years. However, over the course of five years. This formula witnessed a significant increase of 21.3 billion dinars, equivalent to 21.21% compared to the previous year, following a period of slower growth (approximately 3%) in the earlier years.

As for the remaining equity-based financing methods, namely: "Equity partnership (Musharakah), Profit-Sharing (Mudarabah), Manufacturing Contract (Istisna'a), and Benevolent Loan (Qard Hasan)," their volume is very low, almost negligible, compared to debt-based methods (see the figure below). Consequently, it is necessary to determine the share of each sector within the total financing product volume, as illustrated in the following table.

Figure No. (04): Volume of Islamic Finance Products



Source: Prepared and adapted by the researcher

Table 4: Banks' Share of Islamic Finance (%)

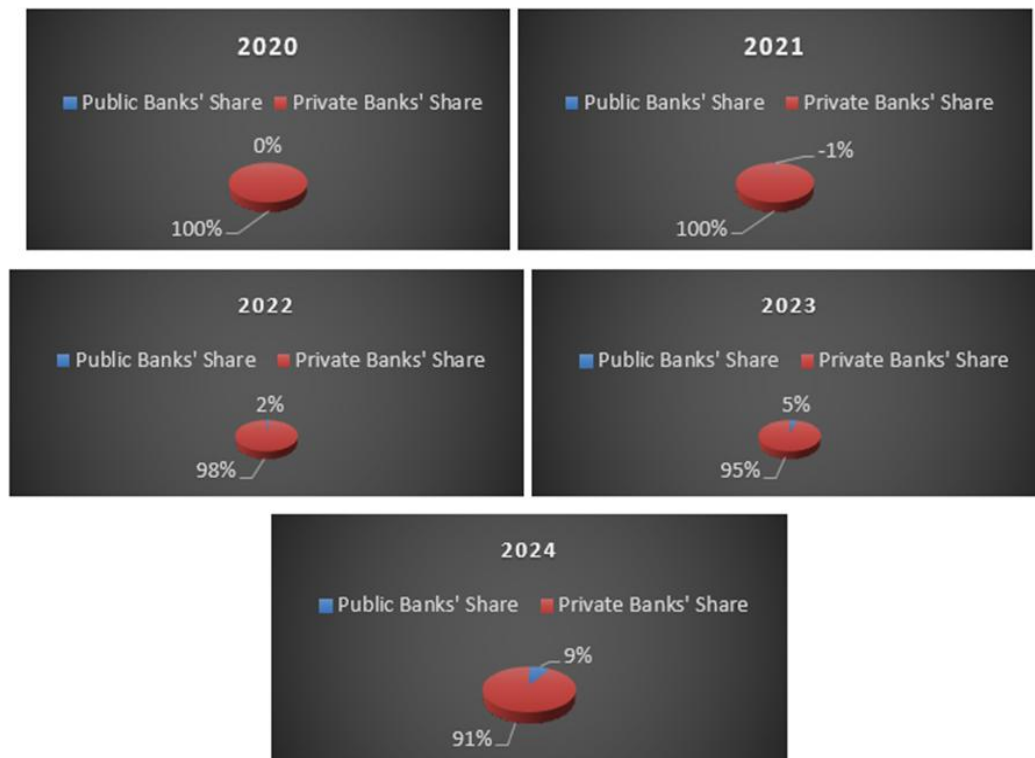
	2020	2021	2022	2023	2024
Public banks' share	0.1	0.5	1.6	4.7	8.6
Private banks' share	99.9	99.5	98.4	95.3	91.4

Source: - Bank of Algeria, Annual Report 2023, Economic and Monetary Developments, June 2024

-Bank of Algeria, Annual Report 2024, Economic and Monetary Developments, June 2025

The table above reveals that private banks still maintain the lead in Islamic financing with high percentages, despite a slight decline in their financing volumes. This trend is attributed to the relatively late launch of Islamic banking windows within public banks; nevertheless, we observe a slow but steady increase in the volume of transactions using Islamic products through these windows. The figure below illustrates this distribution:

Figure 5: Share of Public and Private Banks in Islamic Finance



Source: Prepared and adapted by the researcher

Section Two: Startups and Their Economic Role

1. Conceptual Framework of Startups

1.1 Definition of Startups

The literal meaning of the English term "Start-up" consists of two parts: "Start," meaning to begin or launch, and "up," implying growth. Combined, the term refers to a small project that has just been launched and has begun its growth phase rapidly; typically, these are institutions of a technological nature. (Ahmed Al-Shambari, Ali Ibrahim Surour, 2014, p. 4)

According to Patrick Fridenson, a startup is not defined by age, size, or sector of activity. Instead, it must meet the following four conditions (Wydden: July 14, 2019):

- Strong potential growth.
- Utilization of modern technology.
- Requirement for significant funding.
- Presence in a new market where risk assessment is difficult.

Other perspectives define startups as newly established business entities with low initial costs and the potential for rapid profits, characterized by high scalability and the ability to expand through the adoption of advanced technology. (Samia Hassain, Abdelhamid Lamine, 2020, p. 10)

1.2 Characteristics of Startups:

Startups are characterized by conducting business based on pioneering ideas and addressing market needs in a smart and modern way. Key characteristics include: (Aisha Ben Jaafar et al., 2021, p. 75)

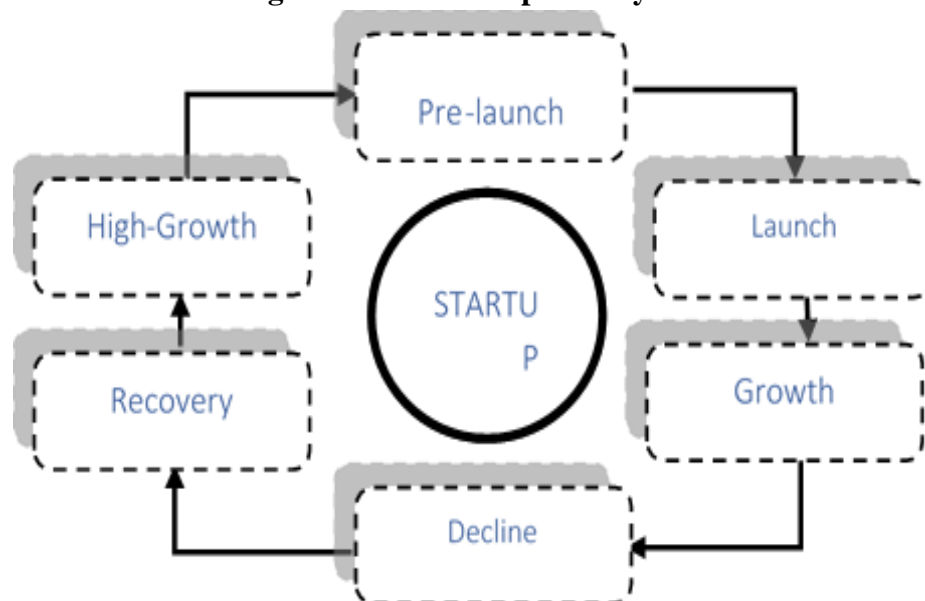
- **Potential for Scalable and Rapid Growth:** A startup has the potential to scale its operations rapidly—increasing production and sales without a proportional increase in costs. As a result, profit margins grow significantly.
- **Technological Dependency:** Business operations are built on innovative ideas that satisfy market demands in a smart and modern way. Founders rely heavily on technology for growth and progress, securing funding through online platforms and gaining support from business incubators.
- **Low-Cost Ventures:** These companies require very low initial capital investments relative to the high profits they generate. Generally, these profits are realized rapidly and exponentially.

1.3 The Importance of Startups: We can summarize the importance and role of startups as follows: (Hamdan Abdul Faouri, 2005, p. 16)

- Reducing unemployment and creating job opportunities.
- Utilizing local resources.
- Eliminating monopolies and achieving regional balance.
- Simplicity and Operational Ease of Technology.
- Lower administrative costs and public expenses.

1.4 The Startup Life Cycle: While startups are characterized by continuous growth, the reality is different. These companies often stumble and go through difficult and volatile phases before reaching their peak (see figure below). The most important stages in the startup life cycle can be highlighted as follows: (Mona Basouih et al., 2020, p. 408)

Figure 6: The Startup Life Cycle



Source: Prepared by the researcher based on various sources

- **Pre-launch Stage:** The project owner presents a prototype of a creative idea. During this stage, they conduct deep research and an analysis of the idea and market conditions, including consumer behavior, preferences, and tastes, to ensure feasibility, future sustainability, and development potential. Following this, founders seek funding, which is initially self-generated, with the possibility of some government assistance.

- **Launch Stage:** The next stage involves launching the first generation of the product or service, which is initially unknown. Perhaps the most challenging aspect for entrepreneurs at this stage is finding investors and financial backers to implement the idea. At this stage, the product requires significant promotion and is often high-priced, Media coverage begins to advertise the product.
- **Growth Stage:** The product reaches a peak, generating high enthusiasm. As the product expands, it reaches its growth zenith, potentially extending its reach beyond its initial creators.
- **Decline Stage:** When the number of competitors increases and obstacles emerge, the project may decline. Despite continued funding from venture capitalists, the project might continue to recede, potentially leading to its exit from the market, especially given the extremely low growth rates at this stage.
- **Recovery:** In the recovery phase, the entrepreneur continues to refine the product and release improved versions. The startup begins to rise again due to applied strategies and the team's accumulated experience. A second generation of the product is launched with adjusted pricing and broader marketing efforts.
- **High-Growth Stage:** The product is fully developed and moves beyond the testing and experimentation phase. It is launched in the appropriate market. The startup experiences continuous growth, so the curve rises sharply, as approximately 20% to 30% of the target audience adopts the innovation. This marks the beginning of economies of scale and the realization of substantial profits.

2. The Economic Role of Startups

Startups play a significant economic role, which can be summarized as follows: **(Adapted by the researcher)**

- Developing production methods and improving service delivery.
- Utilizing available local raw materials, as they rely on local markets for process inputs.
- Providing a source of economic security for families and growth for society; obtaining a suitable income enables individuals to meet their needs and improve their living standards, thus achieving economic security.
- Serving as a distinctive method for redistributing income among members of society by providing opportunities for a wider range of individuals.
- Reducing the volume of imported goods and services while increasing exports, thereby generating foreign currency reserves.
- Creating job opportunities and contributing significantly to reducing unemployment and poverty.

3. Challenges Facing Startups

The most prominent difficulties encountered by startups include the following: **(Mohamed Sebti, 2009, p. 14)**

- **Administrative Challenges:** They face several obstacles when carrying out establishment procedures, which are often complex and slow.

- **Technical Challenges:** Startups rely primarily on the skills and expertise of their founders. Due to limited financial resources, they often cannot afford to hire highly experienced professionals who typically command high salaries.
- **Marketing Challenges:** Financial constraints lead to weak marketing efficiency and limited promotional skills. Furthermore, startups often struggle against consumer preferences for products from large, established companies.
- **Financial Challenges:** This is the most prominent obstacle facing the growth of these institutions and threatening their survival. Startups cannot easily access funding sources, primarily due to their inherent characteristics, which make financing them involve high levels of risk.

Section Three: The Role of Islamic Financing Mechanisms in Stimulating Startups

Providing financing to this category of enterprises through the Islamic Profit-Sharing (Mudarabah) model transforms the bank into the employer and the small business owner into the employee. This arrangement achieves several advantages for both the financing institutions and the entrepreneurs, summarized as follows: **(Dr. Munir Suleiman al-Hakim, 2013, p. 56)**

- It shifts the focus of financing institutions from strictly requiring collateral to focusing on the economic feasibility of the funded projects. Consequently, only projects with a high expectation of success are financed.
- It transforms the focus of financing institutions from fixed-interest lenders to investment partners. This motivates them to exert sufficient effort to ensure the success of the financed project, which is the goal of both parties.
- It shifts the focus of financing institutions from lending for interest to partners participating in the investment. The financed projects generate profits distributed between the two parties according to the agreement contract. Therefore, the role of financing institutions is transformed into an investor, an economic investor, and a partner who provides the startup with the necessary technical, marketing, and advisory support for its success, which is a shared goal for both parties. This is particularly important given that startup owners often lack such experience.
- Financial losses are borne by the bank only if there is no negligence or misconduct by the manager. This protects the employee from losing everything, unlike usurious loans, where the borrower must guarantee the principal and interest regardless of the outcome.
- Financed projects benefit from the monitoring and oversight system imposed by financing institutions. This ensures that funds are not diverted to purposes other than those intended. Financing institutions will not tolerate exposing investments to risks.
- The success of the project depends on the financing institution's careful selection of a partner. He must possess suitable personal qualities such as integrity, religious and ethical commitment, and a genuine desire for the project's success.

As for the Islamic Partnership financing model (Musharakah), it provides sufficient financial support to startups at no cost, enabling them to establish a market presence and ensure their continued existence, not to mention the profits it generates. Furthermore, it offers the possibility for the startup to eventually become independent from the financing Islamic bank. Since the capital of the institution is jointly owned between the founders and the financing bank,

there is no need to provide traditional collateral to obtain continuous funding over successive periods. This gives the partnership financing model (Musharakah) an advantage that attracts innovative young people to establish startups, as it helps emerging small businesses come into existence and thrive persistently despite the risks the bank faces when deciding to finance them. **(Noureddine Meziani & Abeer Lakhchine, 2020, p. 327).**

Additionally, startups rely on the Cost-Plus Financing model (Murabaha), which allows them to acquire their goods on credit, meaning payment is made after the goods are sold. This helps them establish a presence in the market and continue their business activities. This provides them with greater financing flexibility, covers all their other needs, and offers an opportunity to generate profits. **(Noureddine Meziani, Abir Lakhchine, previous reference, p. 329)**

Regarding the Forward sale financing model (Salam) adopted by Islamic banks to finance startups by supplying them with production requirements as "Salam capital" in exchange for receiving the final products at reasonable prices. These goods are then resold for profit. This mechanism contributes to raising the morale of young entrepreneurs and encouraging them to innovate and exert more serious effort to make the emerging enterprise successful, especially if it involves supplying technology, fixed assets, raw materials, and support services for production in exchange for a quantity of products delivered to the financing bank.

This type of financing allows the startup to obtain cash liquidity upon contracting in exchange for a commitment to deliver the agreed-upon product after a specified period. The Forward sale financing model (Salam) can be used for long-term financing, especially if it concerns the fixed assets necessary for establishing factories, In this context, it serves as a viable alternative to Financial Leasing (Ijarah); the bank provides these assets as the capital of the Salam contract in exchange for receiving a portion of the factory's products in installments over suitable, agreed-upon periods. This encourages young people to establish emerging enterprises in this manner, especially if it involves adapting and renovating old factories into new facilities, and starting production and establishing their presence in the market by offering products that meet consumer demand. **(Hussein Rahim Sultani, Muhammad Rashdi Sultani, 2006)**

Conclusion:

Through this research paper, it is evident that startups hold significant importance for economic growth globally, specifically in the Arab world. They serve as a source of added value, contribute to increasing national income, and play a major role in reducing unemployment. Consequently, countries have developed financing mechanisms to support their successful integration into the economy, such as Islamic finance, which emerged in response to market demand. Despite their importance, these entities face several challenges identified in this study. The findings are as follows:

- Islamic finance has attracted a significant client base.
- There are observable limitations within the current Islamic financing processes.
- There is a heavy reliance on debt-based instruments.
- Startups play a vital role in national economies.
- There is insufficient funding to support startups.
- There is a lack of reliance on equity-based financing structures, despite them being the most suitable for the nature of startup ventures.

Based on these findings, it is essential to diversify the Islamic financing product portfolio, specifically focusing on equity-based models for startups, such as Cost-plus financing (Mudaraba), Equity partnership (Musharaka), Manufacturing Contract (Istisna), Benevolent Loan (Qard Hasan).

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