

Theoretical Model for *Zakat*-Based Islamic Microfinance Institutions in Reducing Poverty

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Abstract

The institution of Zakah is instrument instituted by Islam to combat poverty and enhance welfare in the society. Zakah serves as a unique mechanism of compulsory transfers of income and wealth from the haves to the have-nots in the community. This paper seeks guidance from the verses of the Quran and develops a theoretical and workable model of Zakat-based Islamic microfinance institutions (MFIs), which can be used as an alternative approach to reduce poverty. The paper argues that charity-based Islamic MFIs will be financially and socially sustainable as based on the concepts of brotherhood, local philanthropy (decentralization), and volunteer services (joint liability). Zakat-based Islamic MFIs will provide and explore the money for consumption as well as productivity purposes and, thus, can broadly target the economic and social needs of the poorest of the poor. They can help minimize indebtedness and reduce unequal distribution of wealth in society, and also to enhance the ability of the poor to be more productive and not just be dependent of rich people

1. Introduction

Poverty is essentially a classic problem that existed since mankind existed. Poverty is a complex issue, and apparently will continue to be the actual problem from time to time. Many ways were introduced to help the program to alleviate poverty by various country, international Organization, or non-government organization, such as promote infrastructural development by constructing good roads to make transport and communication easy, promote agriculture and farming which are the main sources of income in rural areas, create employment opportunities by constructing small scale industries to enable people get access on jobs, create market opportunities to enable the rural population sell their

goods at favorable prices, good governance and effective administration.¹ The World Development Report (1990) also recommended a dual approach to reducing poverty: (a) efficient labor-intensive growth based on appropriate market incentive, physical infrastructure, institutions and technological innovations; (b) adequate provision of social services, including primary education, basic health care and family planning services. In fact, the reality proved all programs were only temporary, casuistic, and not significant², but there is interesting opinion from Roar Bjornnes founder of the Center for Sustainable Villages, who said that to alleviate poverty there are some long-term program that can implement, among of them are equitable distribution of wealth, justice through both political and economic democracy, a decentralized, ecological and self-sufficient economy, a balance between cooperation and competition, a constitutional right to life's basic necessities, culturally appropriate education, a consumption-motivated rather than profit-motivated economy, agricultural reform, a philosophy of life that supports all human being's interests rather than self-interest. Thus, he suggest the solution to eradicate global poverty only emerge in coalition with sustainable spirituality or a worldview that sees the spiritual unity of all life.³ This statement further emphasized that poverty alleviation programs are very closely related to spiritual matters. Islam as a religion that encompasses universal economic and social issues has also confirmed it. In addition, Islam also provides Zakat as one important instrument to solve social economic problems.

Unfortunately, Zakat as one important instrument in Islamic economics⁴ not yet provide optimal results. The collection and empowerment of zakat funds are still not be able to provide significant impact for the realization of public welfare in general and reduce the poverty level just like it did during the period of *Umar* and *Umar Ibn Abdul Aziz*.⁵ In fact, Zakah has benefits for consumption and also have benefits for productivity, which give capital ability to attempt independently and improve quality of life of recipients. However, there are many unresolved issues that might hinder the impact of zakat on the economy. *First*, the difficulty to finding eligible zakat recipients, it might be due to the conquests that made the *bait al-mal* or public treasury quite robust to undertake significant redistribution programs. Contrary to popular perception we do not have adequate information as to the proportion of collections for the public treasury that came from *zakat*. *Second*, it is commonly argued from the Islamic economic perspective that we need to have an Islamic State and governance, where *zakat* collection and distribution would be given to public sector task. However, historical studies of *zakat* indicate that except for early periods of Muslims, *zakat* has been organized privately or on a nongovernmental basis.

Third, it is a common perception that *zakat* is meant for poverty alleviation. However, a closer study of *zakat* from the perspective of Qur'an indicates that it is more for "purification" of the resources of the qualified *zakat* payers than for any specific goal-oriented purpose. Indeed, this is one of the important reasons why the role of *zakat* has been more like palliative and it has never evolved into an instrument of systematic alleviation or eradication of poverty. It should not be a surprise then that most *zakat* payers are content with payment of *zakat*, without ever thinking about where it went or

¹ Someshwar Singh, *Ten priorities for poverty eradication*, 1999, United Nations Economic and Social Council (ECOSOC) Geneva www.twinside.org, see also sekitto Herbert Grace kisakye, *How to eradicate poverty in rural areas* www.ehow.com

² WDR on social development conference held in Copenhagen in 1995 actually reported that there have been increasing levels of poverty into 1.3 billion from 825 million. In previous report, stated that this program would reduce poverty by year 2000 from over one billion to 825 million. see Kabir Hasan and Mahmood Ahmed, *Substitutability of Zakat Funs In the Budget Of The Government Of Bangladesh*, paper compilation of articles presented in the International seminar on Zakat and Poverty Alleviation in Bangladesh, 14-15 Dec.1998,p.136-161

³ Roar Bjornnes, *Strategies to Eradicate Poverty: An Integral Approach To Development*, paper was published in *The Encyclopedia of Life-support Systems*, UNESCO, 2002

⁴ Main instrument in Islamic Economic, Zakah, Prohibition of Riba, Economic Cooperation, Social Guarantee, Function of Religion. Ahmad Muflih Saefuddin, *Filsafat, Nilai Dasar, Nilai Instrumental dan Fungsionalisasi Konsep Ekonomi Islam*, 1998, GIP, Jakarta, p.46-47

⁵ Shirazi, Nasim Shah (2006), "Providing for the Resource Shortfall for Poverty Elimination through the Institution of Zakat in Low Income Muslim Countries," *IIUM Journal of Economics and Management* 14/1, pp. 1-28

how it was utilized or whether it made any meaningful and sustainable impact on the life of the recipients.

On the other hand, micro finance institutions (MFIs) have proven as institutions that are able to reduce poverty.⁶ MFIs have come as a breakthrough in the philosophy and practices of poverty eradication, and also economic empowerment and inclusive growth. However, given the extent of economic forces and lack of institutional arrangements (such as no legal and regulations for MFIs) in some countries and also the lack of donors, microfinance is an unfinished agenda. The main objective of this paper, therefore, is to shift the focus from mere financial access to poverty eradication and people's empowerment, to sifting the 'integration' into MFIs.

2. The Islamic Worldview of Poverty

Islam being a religion of balance has given equal emphasis on both the spiritual and worldly affairs. As such, the concept of richness or poverty does not only represent deprivation of good and services, but also lack of richness or poverty in spirit. Even, there is no wellbeing measurement at all for the individual Muslim. This is because there is no way we can quantify the spiritual aspect. A Muslim's wellbeing consists of both, material (all worldly possessions) and spiritual (closeness to Allah, His blessings and divine assistance) aspects. But, we cannot apply the same argument for the society. This is mainly because the wellbeing of the society does not have the spiritual aspect. Allah does not judge the society as a whole in the hereafter; for man stand before Allah as individuals. However, in this point, our focus will be on the economic sense of poverty in al Qur'an.

Islam considers that poverty is a structural problem entirely, because Allah has been guaranteed sustenance to every human being or creature. Allah said,

*"So, set you your face towards the religion as a Hanif. Allah's Fitrah with which He has created mankind. No change let there be in Allah's Khalq, that is the straight religion, but most men know not".*⁷

*"And no moving creature is there on earth but its provision is due from Allah. And He knows its dwelling place and its deposit. All is in a Clear Book"*⁸

At the same time Islam has closed the opportunity for cultural poverty by giving the obligation for every individual to seeking earning life.

*"He is Who has made the earth subservient to you; so walk in the paths thereof and eat of His provision. And to Him will be the resurrection"*⁹

And does not restrict the human to seek provision unless under sharia rules

*"Then when the Salah is complete, you may disperse through the land, and seek the bounty of Allah, and remember Allah much, that you may be successful"*¹⁰

Even Islam encourages human to seek provision considering as part of the Allah's worship,

"It is not Birr that you turn your faces towards east and (or) west; but Birr is the one who believes in Allah, the Last Day, the Angels, the Book, the Prophets and gives his wealth, in spite of love for it, to the kinsfolk, to the orphans, and to Al-Masakin (the poor), and to the wayfarer, and to those who ask, and to set servants free, performs As-Salah (Iqamat-As-Salah), and gives the Zakah, and who fulfill their covenant when they make it, and who are patient in extreme poverty and ailment (disease) and at the time of

⁶ See Widiyanto Mislan Cokro Hadisumarto and Abdul Ghafar Ismail (2010) *Improving the Effectiveness of Islamic Micro-financing: Learns from BMT Experience*, Humanomics Vol. 26, No. 1, 65-75.

⁷ Qur'an, 30:40

⁸ Qur'an, 11:6

⁹ Qur'an, 67 :15

¹⁰ Qur'an, 62 : 10

fighting (during the battles). Such are the people of the truth and they are Al-Muttaqun (the pious) ¹¹

"And I created not the Jinn and mankind except that they should worship Me" ¹²
Each creature has sustenance, so they will not starve,

"And so many a moving creatures carries not its provision! Allah provides for it and for you. And He is the All-Hearer, the All-Knower" ¹³

"You will never be hungry therein nor naked. "And you (will) suffer not from thirst therein nor from the sun's heat." ¹⁴

Because provision is Allah's prerogative,

"Then, when they are about to attain their term appointed, either taking them back in a good manner or part with them in a good manner. And take as witness two just persons from among you. And establish the testimony for Allah. That will be an admonition given to him who believes in Allah and the Last Day. And whosoever has Taqwa of Allah, He will make a way for him to get out.) (3. And He will provide him from where he never could imagine. And whosoever puts his trust in Allah, and then He will suffice him. Verily, Allah will accomplish his purpose. Indeed Allah has set a measure for all things" ¹⁵

And has guaranteed the provision for every creature in exactly size of each,

"And no moving creature is there on earth but its provision is due from Allah. And He knows its dwelling place and its deposit. All is in a Clear Book" ¹⁶

So Islam actually encourages people to not fear to the poverty and lack of economic resources:

"Say: "Come, I will recite what your Lord has prohibited you from: Join not anything in worship with Him; be kind and dutiful to your parents; kill not your children because of poverty -- We provide sustenance for you and for them. Come not near to Al-Fawahish (immoral sins) whether committed openly or secretly; and kill not anyone whom Allah has forbidden, except for a just cause. This He has commanded you that you may understand." ¹⁷

In the Islamic perspective, poverty is caused by various structural reasons. *First*, poverty arise because wickedness of man against nature,

"Evil has appeared in Al-Barr and Al-Bahr because of what the hands of men have earned, that He may make them taste a part of that which they have done, in order that they may return" ¹⁸

so the human himself who feel the impact of his wickedness,

"And whatever of misfortune befalls you, it is because of what your hands have earned. And He pardons much. And you cannot escape from Allah in the earth, and besides Allah you have neither any protector nor any helper" ¹⁹

Second, poverty arises because ignorance and stinginess from rich group,

"And let not those who are stingy with that which Allah has bestowed on them of His bounty think that it is good for them. Nay, it will be worse for them; the things that they were stingy with shall be tied to their necks like a collar on the Day of

¹¹ Qur'an, 2 : 177

¹² Qur'an, 51 : 56

¹³ Qur'an 29 : 60

¹⁴ Qur'an, 118-119

¹⁵ Qur'an, 65:2-3

¹⁶ Qur'an, 11 : 6

¹⁷ Qur'an, 6 : 151

¹⁸ Qur'an, 30:41

¹⁹ Qur'an :42 :30

*Resurrection. And Allah's is the inheritance of the heavens and the earth; and Allah is Well-Acquainted with all that you do",*²⁰

*"And collect (wealth) and hide it (from spending it in the cause of Allah)"*²¹

so that the poor people are not able to exit from poverty. *Third*, poverty arises because some people are being arbitrary, exploitative, and oppressive to some other man, like eating someone else's property by way of vanity,

*"And defraud not people by reducing their things, nor do evil, making corruption and mischief in the land."*²²

"O you who believe! Verily, there are many of the Ahbar (rabbis) and the Ruhban (monks) who devour the wealth of mankind in falsehood, and hinder (them) from the way of Allah. And those who hoard up gold and silver and spend them not in the way of Allah, announce unto them a painful torment."

Fourth, poverty arises because the concentration of political power, bureaucracy, and economy in one hand. This is illustrated in the story of Pharaoh, Haman, and Korah are allied in oppressing the people of Egypt in the life of Prophet Musa.²³ In such, in Islam justice and equality has been always as an important instrument in fighting poverty:

*"O you who believe! Stand out firmly for Allah as just witnesses; and let not the enmity and hatred of others make you avoid justice. Be just, that is nearer to Taqwa; and have Taqwa of Allah. Verily, Allah is Well-Acquainted with what you do"*²⁴

Fifth, the poverty caused by external shocks such as natural disasters or wars, so the land which was originally rich turned into a poor. Natural disasters such as that struck this impoverish the people of Saba,

*"Then when We decreed death for him, nothing informed them (Jinn) of his death except a little worm of the earth which kept (slowly) gnawing away at his stick. So when he fell down, the Jinn saw clearly that if they had known the Unseen, they would not have stayed in the humiliating torment. Indeed there was for Saba' a sign in their dwelling place -- two gardens on the right and on the left; (and it was said to them:), "Eat the provision of your Lord, and be grateful to Him." A fair land and an Oft-Forgiving Lord"*²⁵

or the wars that created the poor refugees who were expelled from his country,

*"And there is also a share in this booty) for the poor emigrants, who were expelled from their homes and their property, seeking bounties from Allah and (His) good pleasure, and helping Allah and His Messenger. Such are indeed the truthful.) (9. And (it is also for) those who, before them, had homes and had adopted the faith, love those who emigrate to them, and have no jealousy in their breasts for that which they have been given, and give them preference over themselves even though they were in need of that. And whosoever is saved from his greed, such are they who will be the successful.) . And those who came after them say: "Our Lord! Forgive us and our brethren who have preceded us in faith, and put not in our hearts any hatred against those who have believed. Our Lord! You are indeed full of kindness, Most Merciful "*²⁶

²⁰ Qur'an, 3 : 180

²¹ Qur'an, 70 : 18

²² Qur'an, 26:183

²³ Qur'an, 28:1-88

²⁴ Qur'an, 5:8

²⁵ Qur'an, 34:14-15

²⁶ Qur'an, 59:8-9

3. Guidance of Al-Quran for Poverty Alleviation

In conventional discourse, the causes of poverty can be identified at two levels. At macro level, there are two possible causes of poverty. *First*, the low level of GNP, the people are poor because the country is poor and per capita GNP is low. *Second*, the unequal distribution of income, the people are poor, because the income is concentrated among a few people, leaving others in poverty. At micro level, poverty may be caused by several reasons. A person may be poor because he is unemployed, handicapped, and so on. Or, just because he is born in a poor family and hence is deprived of equal societal opportunities including education, access to gainful jobs, material resources, and so on.²⁷

However, as discussed in section 2, the concept of poverty does not only represent deprivation of goods and services, but also lack of richness or poverty in spirit. Therefore, the teaching of Al-Quran on the alleviation of poverty could be examined from several aspects: supremacy of One Good; humans as *Khalifatullah fi al-ardh*; family empowerment; shuratic role; spending money; prohibition of interest; charity and voluntary services; distribution of inheritance; and zakat.

(a). Supremacy of One God

The Qur'an declares the overall sovereignty of the One God:

*"He it is Who created for you all that is in the earth..."*²⁸

It rejects the idea of any single human being or any particular class of humans having the exclusive right on the available natural resources. Then why do some people have more wealth than others? The Holy Qur'an explains that it is only a favor, a blessing, and a test from God, Who has ordered that your wealth be spent in an equitable and just manner and those less fortunate be given their due share:

*"And Allah has favored some of you above others in worldly gifts. But those more favored will not restore any part of their worldly gifts to those whom their right hands possess, so that they may be equal sharers in them. Will they then deny the favor of Allah?"*²⁹

(b). Humans as *Khalifatullah fi al-ardh*

Humans are commanded by Islam to have a balance between the needs of material and spiritual needs, because adequate worldly needs will spur the achievement of spiritual elevation. Allah said:

*"But seek, with that which Allah has bestowed on you, the home of the Hereafter, and forget not your portion of lawful enjoyment in this world;) means, 'use this great wealth and immense blessing Allah has given you to worship your Lord and draw closer to Him by doing a variety of good deeds which will earn you reward in this world and the Hereafter'".*³⁰

Islam, although not made of material wealth as the main thing, but the poverty of material received fully attention from Islam. In Islam, poverty was very dangerous to belief, character and pattern of human thought and very dangerous to family and community also. Not surprisingly, poverty is one of the most hated by Rasulullah, so that he took refuge in Allah from poverty condition. As narrated by Aishah, Rasulullah pray,

*"O Allah, I seek refuge in You from slander hell, from adzab of hell. And I also refuge in you from the fitnah of richness. And I also refuge in you from poverty defamation ".*³¹

²⁷ Abul Hasan, M. Sadeq, *Poverty Alleviation: An Islamic Perspective*, 1997, Humanomics Journal, International Islamic University, Malaysia, vol.13, iss:3, p.110

²⁸ *Qur'an*, 2:30

²⁹ *Qur'an*, 16:72

³⁰ *Qur'an*, 28:77

³¹ HR. Bukhori

Therefore, Islam against poverty especially to liberates humanity from all the shortcomings, so that he could enjoy decent and dignified life in accordance with the glory of the human. In Islam, at least known for poverty alleviation in two ways, *First*, the suggestion of Islam to explore the natural wealth as the best form of worship human beings on this earth. As Allah said,

*"He it is Who has made the earth subservient to you; so walk in the paths thereof and eat of His provision. And to Him will be the resurrection"*³².

Second, with equality wealth distribution, the most noteworthy feature of the scheme of distributive justice (being a component of a just order) as envisaged by Islam is the assurance of the fulfillment of the basic needs of all, irrespective of the stage of development of a country. To realize this distribution in a fair and equitable, Zakah plays important role, (will be discussed further in section 3(x)).

(c). Family Empowerment

Family becomes the nucleus of the *ummah*. The Qur'an promotes the concept of 'family empowerment' as against the conventional idea of the empowerment of women:

*"And of everything have We created pairs, that you may reflect."*³³

It further declares that both men and women are equal in terms of work and financial rewards:

*"And covet not that whereby Allah has made some of you excel others. Men shall have a share of that which they have earned, and women a share of that which they have earned. And ask Allah of His bounty. Surely, Allah has perfect knowledge of all things."*³⁴

(d). Encouragement to Spend Money

Chapter 53, verse 40 of the Qur'an encourages Muslims to work hard to meet their daily needs. It also directs believers not to hoard money in terms of gold and silver (Ch.9: Vs.34-35) but to invest and circulate money in the economy to generate more jobs. The Qur'an says that:

*"...And whatever you spend, He will replace it; and He is the Best of the providers."*³⁵

It even defines the rules to spend money i.e. forbidding hoarding as well as extravagance and wastefulness³⁶

(e). Shuratic Role

Trustworthiness and justice are the two essential qualities identified for management candidates as described in the Holy Qur'an. It also instructs people to select on merit the best possible person for any role:

*"Verily, Allah commands you to make over the trusts to those entitled to them, and that, when you judge between men, you judge with justice..."*³⁷

Even management is encouraged to seek the opinions of others whenever important decisions are required:

*"And those who hearken to their Lord, and observe Prayer, and whose affairs are decided by mutual consultation, and who spend out of what We have provided for them"*³⁸

³² Qur'an, 67:15

³³ Qur'an, 51-52

³⁴ Qur'an, 4:33

³⁵ Qur'an, 34:40

³⁶ Qur'an, 17:27-30

³⁷ Qur'an, 4:59

³⁸ Qur'an, 42:39

(f). Prohibition of Interest

Interest is prohibited by Islam in the Qur'an. The ideas of trade and charity (Ch.2:Vs.275-276) are promoted as alternatives to help the others. The rationale behind these teachings is to encourage positive economic activities and discourage earnings gained merely through interest (without a person making any real efforts of his/her own). The Qur'an asks lenders to give up whatever remains outstanding in interest or else it will be deemed a war against God (Ch.2:Vs.280-281). As an alternative to income generated from interest, the Qur'an encourages believers to adopt legitimate trading practices:

*"...Allah has made trade lawful and made interest unlawful..."*³⁹

The Prophet Muhammad ^(saw) was asked: "which are the best forms of income generation? He replied; "A man's labor and every legitimate sale." Believers are asked to pay charity if they truly desire the blessings of God:

*"Allah will abolish interest and will cause charity to increase. And Allah loves not anyone who is a confirmed disbeliever and an arch-sinner."*⁴⁰

Charity reduces the level of inequality in society. Money is transferred from the rich to the poor, who borrow mainly for subsistence purposes. It can be argued that charity is more beneficial than economic inefficiency resulting from a reduction in the availability of funds to supply to the poor.

Islamic jurists sometimes confuse the idea of trade as the only viable alternate to interest, without keeping in mind the economic condition of the borrowers and the purpose of the amount borrowed. Loans are generally divided into two broader categories; consumption loans and productive loans. People either take loans for consumption purposes or for productive purposes. The Islamic concept of trade (Ch.2:V.276) only applies in the case of productive loans. Here one can raise the question that is it justifiable to share profit with the poor who are barely able to meet their economic needs? The Qur'an provides the solution to this problem. It promotes the idea of Qardh al Hasan (an interest free loan):

*"If you lend to Allah a good loan; He will multiply it for you, and will forgive you; and Allah is Most Appreciating, Forbearing"*⁴¹

(g). Charity and Voluntary Service

Numerous verses of the Qur'an urge Muslims to give charity (Ch.2:V.265, Ch.2:V.266, and Ch.2:V.272). These verses encourage the rich to contribute towards the welfare of the poor segments of society to seek the blessings of God without taunting those less fortunate (Ch.2:V.263). The Holy Qur'an, at the same time, defines the recipients of the charity:

*"And worship Allah and associate naught with Him, and show kindness to parents, and to kindred, and orphans, and the needy, and to the neighbor that is a kinsman and the neighbor that is a stranger, and the companion by your side, and the wayfarer, and those whom your right hands possess. Surely, Allah loves not the proud and the boastful."*⁴²

The Holy Qur'an does not restrict the concept of charity to merely a donation in cash or kind. It encourages Muslims to voluntarily participate in welfare projects (Ch.61:Vs.11-12). The philosophy is to share and transfer knowledge and expertise to the needy and poor thereby improving their economic plight (caused by the unequal distribution of wealth in society):

³⁹ Qur'an, 2: 276

⁴⁰ Qur'an, 2:277

⁴¹ Qur'an, 64: 18

⁴² Qur'an, 4:37

*“ And it is not your riches nor your children that will bring you near Us in rank, but those who believe and do good works, will have a double reward for what they did... ”.*⁴³

(h). Distribution of Inheritance

Just and proper distribution of wealth is another instruction of the Qur'an which clearly defines rights and ways to divide the property of a deceased relative among the legal heirs as proven in the following verse:

*“ For men is a share of that which parents and near relations leave; and for women is a share of that which parents and near relations leave, whether it be little or much – a determined share. ”*⁴⁴

The logic is to discourage the concentration of wealth in a few hands and to encourage believers to work and earn a living instead of merely living off their forefathers' wealth.

(i). Zakat

The payment of zakat becomes an obligatory of every Muslim. Among the verses are:

*And [recall] when We took the covenant from the Children of Israel, [enjoining upon them], "Do not worship except Allah; and to parents do good and to relatives, orphans, and the needy. And speak to people good [words] and establish prayer and give zakah." Then you turned away, except a few of you, and you were refusing.*⁴⁵
and by referring to following verse:

*Charities (Sadaqaat) shall go to the poor, the needy, the workers who collect them, the new converts, to free the slaves, to those burdened by sudden expenses, in the cause of Allah, and to the traveling alien. Such is GOD's commandment. GOD is Omniscient, Most Wise.*⁴⁶

The above verses show that: zakat is a form of worship (ibadah) of Allah Almighty. As such, we must accept this obligation and the rulings connected to it. The rulings, among others are: first, the obligation of *Zakah* is mandatory on every Muslim who possesses the minimum *Nisaab* (exemption limit or criterion of *Zakatability*) of wealth that enjoys growth or is a result of a growth process, whether the person is man, woman, young, old, sane or insane. The reason for *nisaab* is to ensure that no one is forced to give *Zakah* out of what he or she does not have, and that no wealth goes without *Zakah*. *Nisaab* is also an insurance against the tyranny of the state to tax the poor and or the neediest, and is a reference point for the average Muslim who is not sure whether he possesses the minimum wealth on which *Zakah* is obligatory. Therefore, *Zakah* is a unique, spiritually charged filtering device primarily designed to cleanse one's possession or wealth necessary to protect the owners of wealth against spiritual poverty.

Second, the categories of those entitled to receive it are those considered as economically underprivileged. It shows that Al-Quran teaches us the obligation of *Zakah* as a right for the poor and needy, so as to set every Muslim free from the enslavement of fear and hunger. The *Zakah* is based on the fact that man has created nothing but he adds to the utilities of things. Here, it is a must to give the right of the poor and needy for the cause of Allah, realizing the security and subsistence of every individual in society. Therefore, zakat is aimed to achieve greater income equality through an equitable distribution of wealth by alleviating poverty and reducing the extreme disparities of wealth between the rich and the poor.

⁴³ Qur'an,

⁴⁴ Qur'an, 4:8

⁴⁵ Qur'an 2: 83

⁴⁶ Qur'an,9:60

4. Zakat-Based Microfinance Institution – A Suggestion

Microfinance is one of the most popular tools employed as part of a poverty reduction strategy.⁴⁷ This tool is one of the products of new developmental thinking and policy-making. It is a unique amalgamation of industrial (including financial) and institutional reforms in the present scenario of development economics. This occurred through informal governmental and multi-lateral support, direct support, and the encouragement of non-profit organizations to begin offering microfinance. This growth began in the 1990s, when organizations like UNICEF began to expand their support of microfinance institutions (MFIs). Anecdotal evidence from those programs supports the general belief that “the combination of access to microcredit and basic social services is an effective and cost-efficient approach to enable the poor to pull themselves out of poverty” (UNICEF, 1997: 18).⁴⁸ This anecdotal evidence also supported by several studies (see, for example, Morduch and Haley (2003), Arun, Imai, and Sinha (2006), and Bali, Swain, and Floro (2007)).

In trying to achieve microfinance sustainability or self-sufficiency, cost is an important issue.⁴⁹ In minimizing their cost, MFIs will try to ensure that they only serve the profitable (promising) customers but they might exclude some needy ones. Acknowledging the importance of microfinance for the poor, capital providers (such as government grants) have to provide funds to make sure the microfinance can last long and can provide financing for many customers. Sometimes, subsidy is deployed to compensate formal financial institutions such as banks for entering into risky markets due to high transaction costs and inherent risks.⁵⁰ The subsidies are also used to keep interest rates low for poor borrowers. So, with the funds from the capital providers, microfinance can provide financing to customers with low interest rates (it is normally called ‘subsidized rates’).

In this section, we suggest that we want to expand the list of capital providers that include zakat. Although, other studies such as Dimas Bagus Wiranata (2010)⁵¹, Habib Ahmed (2004)⁵², Russel Power (2009)⁵³, find out the Also suggest the same mechanism, but it lacks the theoretical foundations and workable model.

(a). Theoretical Foundations

The theoretical foundations could be seen from two approaches joint liabilities and decentralization. In the *first* approach, by assuming that the underlying contract in micro-finance facility is based on Qardh al Hassan. Every borrower in a group is liable to loans that are given to the individual in that group. This means the members in the group have jointly connected.⁵⁴ This type of contract practices well-known in Grameen Bank’s Group lending program and AIM in Malaysia.

The benefits of having joint-liability lending (as argued by researchers like Aghion and Morduch (2000), Lensink and Mehrteab (2001), Agarwal et. al (2010) and Zulkifly (2010) could help on: (a) group formation; (b) improve repayment; (c) avoid costly audits; and (d) encourage borrowers to repay their loans with imposing costly sanction.

By forming a group, they says that joint liability lending institutions (JLLI) can do better than conventional bankers in some social contexts because (i) members of a community may know more

⁴⁷ Read further in Smolo, A. and A.G. Ismail (2011) A theory and contractual framework of Islamic micro-financial institutions’ operations, *Journal of Financial Services Marketing*, (forthcoming), p.1-9.

⁴⁸ UNICEF, 1997, *Give Us Credit*. New York: UNICEF

⁴⁹ Cost here includes default rate.

⁵⁰ See, Aghion A. B. and Jonathan Morduch J. (2000), Micro finance beyond group lending, *Economics of Transition*, 8(2), 401-420.

⁵¹ Dimas Bagus Wiranata, and Raditya Sukmana, (2010), *The Power Of Zakah In Poverty Alleviation*, Seventh International Conference – The Tawhidi Epistemology: Zakat and Waqf Economy, Selangor Malaysia

⁵² Habib Ahmed, 2004. *Role of Zakah and Awqaf in Poverty Alleviation*, IRTI, Jeddah,

⁵³ Russell Powell, 2009. *Zakat: Drawing Insights For Legal Theory And Economic Policy From Islamic Jurisprudence*, Seattle University School of Law Legal Paper Series # 10-17. University of Pittsburgh

⁵⁴ The theory of jointly liable borrowers was introduced by Ghatak M. & Guinnane T.W. (1999). The economics of lending with joint liability: Theory and practice, *Journal of Development Economics*. 60:195-228.

about one another; and (ii) poor people's neighbors, may be able to impose powerful non-financial sanctions at low cost. An institution that gives poor people the proper incentives to use information on their neighbors and to apply non-financial sanctions to delinquent borrowers can out-perform a conventional bank.

However, they also highlighted that the transactions-costs argument is under many circumstances, it is only slightly more expensive to administer a group of n loans than to administer a single loan. Group lending enables a reduction in transactions costs per loan. If the projects to be funded are *simple* and *similar* in terms of their characteristics, the time path of their returns, and the geographic location of their activities, then coordinating the lender's dealings with these borrowers by putting them together in a group can save on processing, screening and loan collection costs.

The repayment could also be improved, because theoretically, we can avoid risky borrower and select safe borrower only. A risky borrower could pay the safe borrower to accept her as a partner, but it has to imply large payments till the risky borrower would not want to make them. In addition, researchers like Chatterjee and Sarangi (2005) argue that the repayment rates could also be improved through peer monitoring even when monitoring is costly as long as social sanctions are effective enough or monitoring costs are low enough. As a result the group formation will display positive assortative matching under a joint-liability.

In other perspectives, audits take place less often under joint liability, so expected audit costs are lower and so is the equilibrium interest rate. Hence, social surplus is always higher under joint-liability contracts. In short, a joint-liability contract might make lending possible. Although, the benefits of joint liability are widely accepted, but several researchers such as Bond (2002), Chatterjee and Sarangi (2005), Asyraf (2006) and Zulkifly (2010) have highlighted several concerns. Bond (2002), in his research on joint liability has found common feature of financial intermediaries. It is the welfare of one borrower is adversely affected by the poor performance of other borrowers. Therefore, he suggests a degree of joint liability among the borrowers of a financial intermediary. He provides an explanation for this observation. It demonstrates that formalization of a financial intermediary as a delegated monitor, intermediation with joint liability between borrowers Pareto dominates intermediation without joint liability. He explains the existence of joint-liability between the borrowers of a financial intermediary. Consider an intermediary whose income is too low have to pay the face value of investor claims. He can default on the investor claims or go to the subset of borrowers who still have resources, and request a higher payment. This second option entails the borrowers monitoring the bank to make sure these extra funds are really needed, and this option is cheaper in terms of aggregate expenditures on monitoring.

Since introducing a degree of joint liability among borrowers reduces total monitoring costs, it is possible to make all parties better off: The payments to the investors can be reduced, since they monitor less, while the expected payment made by the borrowers can be reduced (i.e. the interest rate lowered), since in aggregate the intermediary and investors monitor less. Decrease the payments from the intermediary to the investors.

However, in Islamic finance, group-based lending approach is deeply described in Ibn Khaldun's concept of '*Asabiyah* or social solidarity'.⁵⁵ By adopting group-based lending approach, Islamic micro-finance institutions (IMFIs) may offer various Islamic financial products and services without compromising on the issue of institutional viability and sustainability.

In addition, the qardh contract might also allow the hiwalah contract be introduced in case of default. The borrowers who are heavily under debt and cannot generate enough to pay off their debts. They can be jobless or earning a little, or those who may be left with nothing if they pay off all their debts, or those who have been reduced to poverty due to unforeseen calamities like paying heavy penalties and fines, failure of business etc. This means Zakat can be channeled to Hiwalah fund.

⁵⁵ "cooperate in righteousness and piety, but do not cooperate in sin and aggression" (Qur'an, 5:2)

(Hiwalah is a transfer of debt from the transferor (*muhi*) to the payer (*muhalalayh*)).⁵⁶ In this case, the poor people as in debtors or *Muhi* (transferor), and the IMFI as provider of fund is a *Muhal* 'Alaihi (the payer). this contract also help to reduce the difficulties of the poor. So when he started his business, he is not no need to fear that the funds will run out just to pay the debt.

The *second* approach is based on decentralization policy. *Zakah* system provides a permanent mechanism from within the economy, to continuously transfer income from the rich to the poor, so that whatever is the number of poor people in a society or whatever are the causes of poverty there is always a continuous flow of transfer to take care of the welfare of the poor. The allocation of *Zakah* and disbursement between the poor, needy and other recipients on one hand and between capital goods and consumption goods on the other, as well as the principle of *tamlik*, which means giving to the poor and needy on a grant basis, are considered to lead to more specific approach in dealing with the problem of eradication of poverty, since *Zakah* addresses specific poor groups.

The IMFIs is able to integrate capital provider (from zakat) and capital user (or IMFIs' client). The ability could be seen from the following fundamental strengths of IMFIs:

i. Access of the poorest of the poor to the IMFI

The poor are normally excluded all the times from economic and financial assistance of the formal financial institutions.

ii. Assessment of the financial health of the poor

Many failed micro-finance (MF) programs owe their failure to inadequate evaluation of the client's financial condition. Provision of micro finance does not stand to reason for a person in need of social safety nets resulting in the funds being consumed away instead of being invested. The poor come in disparate categories with varying needs of consumption and productive investment and risk of delinquency and default. Microfinance programs involving indiscriminate funding of the poor, such as, most government-managed ones are destined to fail. This is one of the cornerstones of MF "best practices" that assert the government should have no role in direct or indirect provision of financial services and its role should be restricted to providing a supporting and enabling environment. Insistence on beneficiary stake is of course, a device to reduce moral hazard and enhance efficiency

iii. Transformation of unproductive assets of the beneficiary

Often the poor own high-market-value assets, such as, land in a prime city location without being able to derive income or benefit from the asset. While ownership of land does provide them with a protection against unforeseen adversities, this is an uneconomical and wasteful method of insurance. What is desirable here is a way to transform the unproductive asset into a productive one that could generate income. The original asset is not lost but transformed into an income-generating one.

The price at which the original asset is disposed of must be fair and should not take the form of a distress sale resulting in loss of value to the seller. Contemporary finance theorists find the auction system to be the most efficient process of discovery of the intrinsic worth or the fair price. The involvement of larger community in the poverty alleviation program is also highly desirable for success of the program. For many contemporary successful IMFIs, the right strategy is to involve zakat in the process.

iv. Meeting of basic needs on a priority basis

Once again this highlights the need to take into account the consumption needs of the clients before expecting them to create wealth. The realization about the need for a social safety net and to link the same to micro finance at a later stage has come only recently in the MF industry.

v. Direct involvement of the program in capacity building

This strength demonstrates a unique form of commitment and involvement on the part of the Zakat in the program of poverty alleviation. The involvement could not be more direct and the commitment more pure.

vi. Technical assistance in the form of imparting requisite training to the beneficiary

⁵⁶ Shari'a Standard No.7: *Hawala*. Definition of *hiwala* from Shari'a Standards by Accounting and Auditing Organization For Islamic Financial Institutions (AAOIFI) Rabi' I 1424H – May 2003

The need to establish an effective linkage between financial assistance and technical assistance is emphasized among MF professionals as never before. Also the importance of impact assessment can be hardly overemphasized.

vii. Transparent accounting of operational results

In short, the Islamic approach to poverty alleviation is more inclusive than the conventional one. It provides for the basic conditions of sustainable and successful microfinance, blending wealth creation with empathy for the poorest of the poor. There are certain aspects of the Islamic approach that need added emphasis. One, transparency through meticulous accounting and proper documentation is a fundamental requirement of financial transactions in the Islamic framework.⁵⁷

(b). Workable Model

The Zakah Investment-Micro Finance Model is an idea which tries to integrate charity with MF and bring Islamic finance closer to the objectives of Shariah. The key features of this model are as follows: The Qur'an provides the concept of brotherhood and social welfare (as discussed in section 3) via zakat in order to reduce the inequality distribution of income and poverty. The Qur'an also directs all Muslim to participate, either as donors or as beneficiaries. The model works as follows:

i. Sources Of Funds

The major sources of funds are motivated by the following verses:

*"And in their wealth there was the right of the Sa'il (who asked for help) and the Mahrum (who could not)"*⁵⁸

This section elaborates on the major sources of financial Zakat In Islam. Islam was probably the first religion to introduce the concept of zakat, to reduce socioeconomic gap between the rich and the poor,

ii. Usage of Funds

No doubts that reduction in social and economic gaps between various segments has greater benefits than the economic inefficiencies created through limited availability of funds for the poor. Islam also defines in detail the usage of the available money of zakat. *First*, basic necessities, Islam considers the primary responsibility of the societies and government to care about the needs of the poor people and ensure necessary facilities for a decent life for all its citizens. *Second*, education and productivity, Islam Consider the quest for new knowledge as equal to faith in any Muslim. Allah said,

*"Then high above all be Allah, the True King. And be not in haste with the Qur'an before its revelation is completed to you, and say: "My Lord! Increase me in knowledge"*⁵⁹

Third, Qardh al Hasan (benevolent loan), Islam does not limit zakat to meet the consumption requirements of the poor, but also introduces and provides the unique idea to explore the zakat for productive purpose.⁶⁰

Therefore, the Zakat Based-MFIs have the following features:

Zakat Based Islamic MFIs	
Sources of Funds	Zakat
Usage of funds	Economic Production and Development
Type of charges	Interest free
Nature of Funds	Charity and Obligation
Nature of recovery	Only Community pressure

⁵⁷ Qur'an, 2: 282

⁵⁸ Qur'an, 51:19

⁵⁹ Qur'an, 20: 114

⁶⁰ Kaye R, Islamic Financing and The Saudi Entrepreneur, Reading from the field, 2007, Paper presented at the 1st International Conference on Inclusive Islamic Financial Sector Development, University Brunei Darussalam, April 17-19

Type of Contributors	Obligatory
Type of Empowerment	Family or Individual
Type of motivation	<i>Taqwa</i> , Obligation, Brotherhood
Level of Participation	Compulsory participation by every individual of the society

The proposed IMFIs will raise funds from the *Zakat* (compulsory charity), *Shadaqat* (optional charity), and *Qardh Hasan* (interest free deposit). Because *Zakat* and *Shadaqat* will reduce the need to diversify funds meant for investment to unproductive use, thus improving the overall returns on investment and decreasing the probability of default on loans.⁶¹

The major contribution of *Zakat* Based-IMFIs is to provide capital to the poor and needy to build their own businesses, and also provide them with the incentive to work diligently to return the principal amount, without having to pay any additional charges. In case, where the beneficiary is unable to repay his or her loan, they become *ghaarim* (one burdened with debt), as discussed above. The beneficiary thus becomes a legitimate recipient of *zakat* to pay back what he or she owes. Hopefully, this mechanism will reduce the stress of risk in business for the recipients and create an enabling environment for productive work and, thus, increased economic opportunities in society.

5. Conclusion

The objective of this paper is to shift the focus from mere financial access to poverty eradication and people's empowerment, to sifting the 'integration' of *zakat* into MFIs. By using the theoretical foundation of joint liabilities and decentralization, this study shows that: first, joint-liability contract can save in term of processing, screening and loan collection for the IMFIs. In short the theory is joint liability contract can reduce transaction cost. Second, the decentralization policy is used to make sure that *zakat* transfer continuously flows for the welfare of the poor. Third, the contribution of *Zakat* Based-IMFIs is to provide capital to the poor and needy to build their own businesses, and also provide them with the incentive to work diligently to return the principal amount, without having to pay any additional charges.

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⁶¹ Habib. A (2002) Financing Microenterprises: An Analytical study of Islamic Microfinance Institutions, 2002, Islamic Economic Studies, 9(2), p.27-62

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