

Integrating *zakat* and Islamic charities with microfinance initiative in the purpose of poverty alleviation in Indonesia¹

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Religious belief is a common human characteristic that is largely neglected within mainstream development practice and theory. Religious principles and social teaching however, can positively contribute to poverty alleviation. This paper explores examples of how Islamic principles of charity and finance can strengthen microfinance as a poverty alleviation strategy. It describes two cases study of Baitul Maal Muamalat Indonesia and Baitul Qiradh Baznas in Indonesia. The study shows although they have utilized zakat and Islamic charities as microfinance's source of fund, they only targeted low income people with some form of employment. It can be argued that zakat and Islamic charities should be functioning as an additional fund to provide social services for the extremely poor and combined it with the commercial fund to achieve better outcomes in poverty reduction.

Key words: Zakat, Islamic charity, Islamic Microfinance, Poverty Alleviation

I. Religion in Development

Religious belief is a common human characteristic. Eighty percent of the world's population professes religious faith, including 1.3 billion Muslims worldwide (20 per cent of the global population). Nearly 70 per cent of all Muslims live in Asia (including the Middle East), while just over a quarter live in Africa. Indonesia's nearly 200 million Muslims make it the country with the highest number of adherents to this religion. Despite this widespread religious adherence, religious belief has long been ignored in mainstream development paradigms and by development practitioners (both locally and at the international level). The values and attitudes associated with religious beliefs within countries can affect both public policy settings as well as social behaviours and yet, they are not explicitly considered within mainstream development agendas. Yet, religion should be considered a positive and constitutive force that can be harnessed to improve the material lives of the poor.

Religious practice involves 'the worship of a personal supernatural deity, a revealed scripture, a divinely ordained code of laws, and an assortment of institutions and communal structures in which the religion is observed' (Segal 2009, p. 4). Religious belief is relevant to both social and private realms. Religious belief systems provide a meaning for existence through which adherents interpret their own circumstances and make decisions on how to act and interact in wider society. These judgements are based on religious teachings that contain precepts on how to live a righteous life, including how to respond to those who are materially poor. This is particularly important when we consider that (using the most common World Bank measure of

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poverty) over 1 billion of the world's population live in poverty and exist on less than US\$1 a day (and nearly 3 billion live on less than US\$2 a day). More than 1 billion people around the globe do not have access to clean water, 115 million children do not attend primary school and 10 million children die each year of preventable illness (World Bank 2010).

The international community actively began to address the circumstances of the poor following the end of the World War II. Growing out of the successful reconstruction of Europe (the Marshall Plan), the international community began its efforts to 'modernise' *underdeveloped areas*. Religious organisations also shared this desire to improve the lives of the poor, but their response and actions greatly pre-date this relatively recent secular focus. Responding to the needs of the poor has a long history in many religious groups and individuals motivated by concepts of religious charity to provide material care and comfort. However, there has been a lack of recognition of the role played by religious organisations and individuals motivated by their religious belief in this regard. Indeed, a review of the relevant development studies literature suggests that efforts by religious bodies to improve the material conditions experienced by the poor have not been made.

This paper is interested in one aspect of poverty alleviation: microfinance. In particular it is interested in understanding how microfinance as a poverty alleviation tool aligns with poverty alleviation as understood within Islamic religious teaching. This paper will introduce a new model that integrates both the principles of Islamic charity as well as microfinance to better achieve sustainable poverty alleviation outcomes. This model will be tested by reviewing the practices of two Islamic microfinance institutions. This paper is set out as following: this section has introduced the paper. Section 2 will discuss how poverty alleviation is understood and responded to within Islamic religious teaching. Section 3 describes Islamic microfinance as poverty alleviation strategy. An integrated model of Islamic microfinance is introduced in Section 4 before this is illustrated by an Indonesian case study in Section 5. Section 6 concludes this paper.

II. Islam and Poverty Alleviation

Poverty in Islam

Islam is a very practical religion. Muslim teaching is not just concerned with religious or spiritual practice (belief in one God, prayer, charity, fasting and pilgrimage), but also with social etiquette. 'For example, the Qur'an advises Muslims not to visit people when they are resting and provides guidelines on how to greet one another, dress appropriately and how to interact with the Prophet' (Seed 2008, p. 73). It also sets out very detailed legal directives addressing marriage, divorce and custody of children. In Islam, faith is closely linked to action. The Arabic term for righteousness is *birr*, which also translates as social justice and love. Therefore a righteous Muslim is also a Muslim who loves others and seeks social justice for the poor and disempowered. Very early in the Qur'an help for the poor is made a central tenet of Muslim faith.

Righteousness is not to turn your faces towards the East and the West; the righteousness is her who believes in Allah, the Last Day, the angels, the Book and the Prophets; who gives of this money, in spite of loving it, to the near of kin, the orphans, the needy, the wayfarers and the beggars, and for the freeing of slaves; who performs the prayers and pays the alms-tax. Such are

those who keep their pledges once they have made them, and endure patiently privation, adversity and times of fighting. (Qur'an 2:177)

In this sense, Islam requires more than faith; it requires action based upon that faith. The underlying principle of Islamic social teaching that is most relevant to development is that of equality (Shepherd 2009). This sense of equality is clearly evident in its approach to the allocation of scarce resources, and it is argued that Islam is 'directed towards the creation of a meaningful and positive equality among human beings. As such the Islamic purpose cannot be realised until genuine freedom to human beings is restored and freedom from all forms of exploitation – social, spiritual, political and economic – assured' (Rahman 1967, p. 103). Just before his death, Muhammad made it clear that all Muslims are equal and deserving of respect: 'You know that every Muslim is the brother of another Muslim. You are all equal.' The very marked shift in social relations during Muhammad's rule is a clear indication of how powerful this sense of equality was. Moreover, the Qur'an specifically relates the neglect of the poor with the neglect of religion. *Have you observed him who denies religion? That is he who repels the orphan, and urges not the feeding of the needy* (Qur'an 107:1–3). The importance of meeting basic needs was very evident to the desert dwelling Arabs of this time. Water, food and shelter are necessary for subsistence and so access to these goods was vital. It was also evident that people had to work hard to be able to gain these goods. Life was hard and living conditions difficult; hard work was required to survive. Certainly, the personal experiences of the Prophet, working as a shepherd and then a merchant, reflected the importance of a work ethic. The Qur'an makes it clear that hard work is required: *Man will get nothing but what he strives for* (Qur'an 53:39). As Yasien Mohamed suggested, 'Islam is a world-affirming religion' (2006, p. 416). If Islam is to be characterised in anyway, it is its practical nature that most differentiates it from the other world religions.

Islam and Poverty Alleviation

Muhammad was a political leader as well as prophet. Thus from Islam's genesis, religious beliefs and faith has been grounded in the day-to-day circumstances of its adherents. It is this practical and political focus that Islam has much to engage with in terms of modern development concepts, such as poverty. The problem of poverty and destitution though is not new and has been faced by all civilizations. Qardhawi (2009) examines the position of the poor before Islam in ancient civilizations such as Egypt and Babylon, and notes their poverty was a result of their having no access to the land and productive activities. In fulfilling their basic needs, poor often sold themselves as slaves to the rich. Modern poverty also remains largely a function of a lack of access to productive capital. Islam directly addresses this issue by establishing the importance of social justice, social insurance, and social solidarity within the Quran and in the Sunnah of His Messenger.

The importance of equality within Islam is clearly evident in the focus of resource redistribution through Islamic charities such as *zakat*, *awqaf* and *shadaqa*. Leaman (2006) notes fighting for the poor is considered as fighting for Allah's cause and is equivalent to fasting and prayer. The obligation of paying *zakat* in Quran is stated thirty times and most of them associated with the obligation of prayer (*salat*) in the same verse. Hence, we may note that Islam is very concerned poverty and equality.

In Islam, poverty is defined as the inability of individual in meeting the five basic requirements in life consisting of religion, physical self, intellectual or knowledge, offspring and wealth (Hassan, 2010). There are two terms in Quran to express the condition of poverty: *Faqr* and *Maskanah*. The *shadaqa* (*zakat*) are only for the *fuqara* (poor) and al *masaakin* (the needy)..... (Qur'an 9:60). *Fuqara* is the plural form of *faqr*, indicating the condition for those who are unable to adequately provide for their own basic needs, while *Al Masaakin* is plural for *Maskanah* which are those people who are destitute and extremely needy. Although, Islamic scholars have long debated which group is most in need in their lives, Qur'an states that both of *faqr* and *maskanah* are eligible for being Islamic charities recipients. Islamic charities ensure the poor to obtain sufficient basic material necessities of life by wealth transfer and income distribution.

Poverty Alleviation tools in Islam

Islamic charities are major instruments that have central roles in poverty alleviation. The broad term of charity is called *shadaqa*, when it is compulsory, it is called as *zakat* and when its benefits is expected to be permanent, it is called *shadaqa jariyah* or *waqf* (Obaidullah, 2008). *Zakat* and *shadaqa* engage in poverty alleviation through income distribution and wealth transfer. On the other hand, the *waqf*– the perpetual charity, is used for long term investment to improve the non-income aspect of the poor such as health, education, physical resources, and employment (Hassan, 2010). Since Islamic charities include various types that have distinctive characteristic. Hassan (2010) provides a comparison of Islamic charities as poverty alleviation tools as below:

Table 1: Comparison of poverty alleviation tools in Islam

	Zakat	Shadaqa	Waqf
Compulsory/ Voluntary	Compulsory	Voluntary	Voluntary
Rate	Fixed rate	Any amount	Any amount
Spend	Generally spent in one year	Generally spent in one year	Generally Capitalized
Investments	Generally not invested – needs to be discharged as soon as possible	Generally not invested – may be discharged according to need and mandate	Invested in social or economic asset
Time for payment	Generally paid in Ramadaan	Can be paid at any time	Can be paid at any time
How payment is made	Generally paid in cash or stocks	Can take the form of any asset	Can take the form of any asset – cash, land, coins, jewellery

Source: Hassan, Kabir, 2010

1. *Zakat*

The word of *zakat* in Arabic means to grow or to increase and when referred to people it means to improve or to become better (Qardhawi 2009). In Sharia, the word *zakat* refers to the determined share of wealth prescribed by God to be distributed among deserving categories. Islam considers that all things belong to God; therefore possession has to be purified for those

who needed. Many Islamic scholars argue that *zakat* will create cleanliness of the inner soul, increase wealth and help the poor to grow (Qardawi 2009).

Although *zakat* is compulsory charity in Islam to fight the poverty, the awareness of Indonesian Muslim of paying *zakat* is very low. The amount of *zakat* collected per year is far behind the potency of *zakat*. For example BAZNAS, the largest *zakat* institution in Indonesia, only collected US\$ 2,6 million in 2010, where the national potency of *zakat* on household income reaches US\$ 61 trillionⁱ.

Depending only on *zakat* as microfinance funds, also posts additional problem since in majority *zakat* is paid during Ramadhan, while the poor requires help throughout the year. To solve this problem, several *zakat* institutions in Indonesia have developed a partnership with the business enterprises to deduct *zakat* from the employees' salary directly before being paid every month. Furthermore, the effect of *zakat* fluctuation can be minimized by creating *zakat* fund that can be used in the whole year (Chalikuzhi, 2009).

2. *Shadaqa*

The word of *shadaqa* comes from the root word of *sidq* which implies giving away goods and funds for the sake of God in expression of faithfulness and in realization of the belief in resurrection and afterlife (Qardawi 2009). In current life *shaqada* usually called as charitable donation for those who needed in the sake of God. Obaidullah (2008) notes that *shadaqa* may include various forms of charity, such as, *tabarruat* (donations), *heba* (gifts), *infaq* (charitable spending) and may indicate any act of kindness and charity.

Since it is voluntary, the total amount *shadaqa* collected through the institution/organization is very low. It is more common to give the *shadaqa* to the poor directly, instead of through the institution. *Shadaqa* is usually given to the closest relative or neighbors who are in need. Due to the cultural value, it can be argued that the institutionalization of *shadaqa* faces more challenge than *zakat*. However, the increasing awareness of corporate philanthropy and corporate social responsibility as form of services to the community creates a potential to generate more *shadaqa* from commercial business rather than personal *shadaqa*.

3. *Waqf*

In Arabic language, *waqf* means to stop, to contain or to preserve. In sharia, *waqf* is holding certain physical assets and preserving it to the long term benefit for the society. Ahmed (2007) notes the objective of *waqf* are including the provision of religious services, socio-economic relief to the needy and the poor segment, education, environmental, scientific, and other purposes.

The forms of *waqf* asset mostly are land or building that used for the religious/society purposes. However, there is significant growth in cash *waqf* worldwide. The nature of *waqf* spending that can be capitalized, is potentially utilized to increase the capital base of microfinance. Ahmed (2007) notes the return of *waqf* funds is important to provide the subsidized microcredit or even the interest free credit such as *qard Hassan* without reducing sustainability of the institution.

III. Islamic Microfinance for Successful Poverty Alleviation Strategy

Microfinance is an important intervention to reduce poverty. Microfinance offers basic financial services for poor people. The Consultative Group to Assist the Poor (CGAP) defines microfinance as the supply of loans, savings and other basic financial services for the poor. Providing financial services for the poor is neglected by formal financial institutions as this group of people is inherent to high risk due to their incapability to meet the standard and requirements of formal financial institutions. Zeller and Meyer (2002) argue that the lack access of financial services constraints the ability of poor people to acquire assets, start a business, finance their emergency needs and increase their welfare. Improving access to financial services through microfinance in some extent is believed to solve these problems. As the financial institution, microfinance has to pursue dual objectives: obtaining financial sustainability and serving the poor as social objective.

Hassan (2010) notes that the Islamic approach to poverty alleviation ideally involve comprehensive approaches including (a) increasing income levels with pro-poor programs, (b) achieving an equitable distribution of income and (c) providing equal opportunities for all social segments. Microfinance with its social objective can support the achievement of those approaches. The role of microfinance in poverty alleviation has been drawn by Zeller et al. (1997) in three pathways by improving income generation through providing production credit and saving for asset accumulation, decreasing insurance cost through holding more efficient asset and liability, and smoothing consumption by providing consumption credit. Practically, microfinance will contribute to the poverty alleviation agenda through supporting micro-credit, micro-saving, micro-entrepreneurs and constraint the practice of informal money lenders. Furthermore, microfinance can be used as a strategy to distributing zakat and Islamic charities for better outcomes in poverty alleviation.

Although many studies have been conducted in advancing microfinance practice, many institutions still have faced many obstacles in providing services for the poor. Setting the optimal interest rate to achieve sustainability is the most difficult task for MFIs. In practice, most MFIs charge interest rate higher than commercial financial institutions. They argue, the high rate is reasonable to cover the high operational cost and it is still lower than informal money lenders. However, over charging interest rate will cause microcredit unaffordable for the poor and will be lowering the repayment rate. The evidence shows, when the interest rate exceed by 60% per annum, the MFI will not generate profit because lack of microcredit demand.

Another limitation of microfinance is it is only targeted the upper level of the poor. Low income households – the target client of microfinance face multiple constraints on earning generations. They often lack of skills and education or even severe with illness to generate income through productive activities. Sudaresan(2008) noted that in many developing economies, there are significant percentages of population that unable to access formal financial institutions due to the fact that they are extremely poor, ill educated and have no sustained opportunities for employments.

The literature shows that the clients of microfinance need more than financial products; they require non-financial services to support their businesses and daily lives. Microfinance clients are often constrained by poor health and/or illiteracy which limit their capacity in utilizing the

financial services available. Some scholars argue that an integrated model of microfinance that offers both financial and non-financial services is needed for poverty alleviation agenda. However, providing non-financial services requires extra cost and this could jeopardize the financial sustainability agenda. Several MFIs provide non financial services by relying on the grants of the donor funds, which are not easily available to all MFIs.

Understanding the limitations of current practice of microfinance, there is an opportunity to create a powerful microfinance practice, which not only serves the upper level of the poor but also provides both financial and non-financial services without disturbing a financial sustainability agenda. We argue that Islamic finance is embedded with several characteristics that are able to reduce the limitation of microfinance. Both microfinance and Islamic finance share the same basic concepts in how they create financial services for the poor. Both microfinance and Islamic finance encourage entrepreneurship, promote risk sharing and encourage the poor to take part in poverty reduction activity (Ahmed 2002, Dhumale and Shapcanin 1998; Siddiqi 2008; Obaidullah 2008). Furthermore, the availability of zakat and Islamic charities in Islamic world can enhance the capital base of microfinance and to improve the wellbeing of the extremely poor clients.

The application of Islamic finance on the microfinance practices has several advantages that can increase the viability and sustainability of MFIs. They might take the benefits by implementing Islamic scheme of transactions, targeting on the family rather than focusing only on women clients, using religion as social capital as well as obtaining other source of financing from Islamic charities.

The benefit of Islamic finance in microfinance initiative

Implementation of Islamic scheme of transaction

Abdul Rahman (2007) argues that Islamic finance has many potential to provide various schemes and instruments which is suitable with microfinance practice. This argument is supported by Dhumale and Shapcanin (1998) who noted that mudarabah, musyarakah and murabahah muajjal are three basic principles of Islamic finance that can be applied to build viable microfinance institutions. In mudarabah and musyarakat contract, microenterprise and MFIs may develop a partnership in conducting project under PLS mechanism. This mechanism can be applied either in saving mobilization as well as in the project financing. In the case of success, the profit will be distributed at the predetermined rate but when the project is fail; the losses will be taken by the MFIs. Here MFIs take place in monitoring and providing entrepreneurs with sufficient skill to avoid failure of the investment. This scheme would also encourage the role of microfinance as social development vehicles. Murabahah is another scheme that possible to apply in MFI practices. Murabahah is similar to the trade contract in the scheme working capital loan and similar to leasing in the context of long term investment in fixed assets. This is the asset backed transaction which would reduce the possibility of misuse funds other than being requested.

Islamic schemes of transaction guarantee and encourage the participation of every segment of society. In particular, the implementation of Islamic participatory approach in fund mobilization and financing promotes justice, brotherhood, social equality and financial inclusion of the poor (Dusuki 2008).

Family targeting rather than focus on women clients.

One success factor of Grameen in increasing repayment rate is focusing on the women clients. Women are more reliable in loan repayment and will use the money for family purposes. However, Ahmed (2002) argues that focusing on women as target clients might raise several problems. Sharing the same idea, Rahman (1999) notes asymmetric problem might happen when men have initiative to take loan and control the use of the funds receive by female member of family. Furthermore, targeting women also might create high tension in family as men put pressure on women to obtain credit because it is easier for women to receive credit, but men use the fund for their purposes. In addition, many studies have found that credit given to women generate low rate of return since women engage in low risk and low productive activities (Rahman and Khanker 1994). In addition, Obaidullah (2008) notes that focusing only on women are sensitive issues in Islam. Therefore, Islamic MFIs prefer to target family rather than women in the family. By doing this, Islamic MFIs would reduce the moral hazard and adverse selection problem in giving loan as risk are being sharing in whole family.

The importance of religion as social capital

Group based lending mechanism is often applied by MFIs to reduce the risk of high non-performing loans. This mechanism is well known introduced by the Grameen Bank and widely applied around the world. This mechanism utilizes the concept of social capital by enforcing the share norm, value and behavior through formation of peer guarantee mechanism to replace the physical collateral in lending practice. Dusuki (2008) notes that group based lending mechanism is not alien in Islam as it has been known by the concept of *as sabiyah*. He argues that both *as sabiyah* and social capital share the same positive values such as teamwork, sense of belonging, cooperation and trust. If this concept is based on the religion paradigm would be beneficial for the success of the application of group lending mechanism. This idea is supported by Ahmed (2002) who notes that Islamic MFIs may take advantage from religion perspective as loan repayment are the obligation for Moslem.

The availability of various sources of financing

Another important advantage of Islamic MFIs is the availability of various sources of financing. Incorporating Islamic charities as the MFI's source of financing will be beneficial since this fund is non-interest bearing. Islamic MFIs may use this fund as complementary funds to finance the non investment activities such as assisting the poor in their basic needs, conducting training to enhance the skill and capability of the borrower, and other community development activities. In addition these complementary funds will reduce the possibility of using the loan obtained for non productive purposes (Ahmed, 2002). As a result, the default rate can be minimized.

Therefore, it is argued that Islamic microfinance schemes do differ from traditional approaches in terms of their client focus, understanding of social capital and accessing various forms of capital.

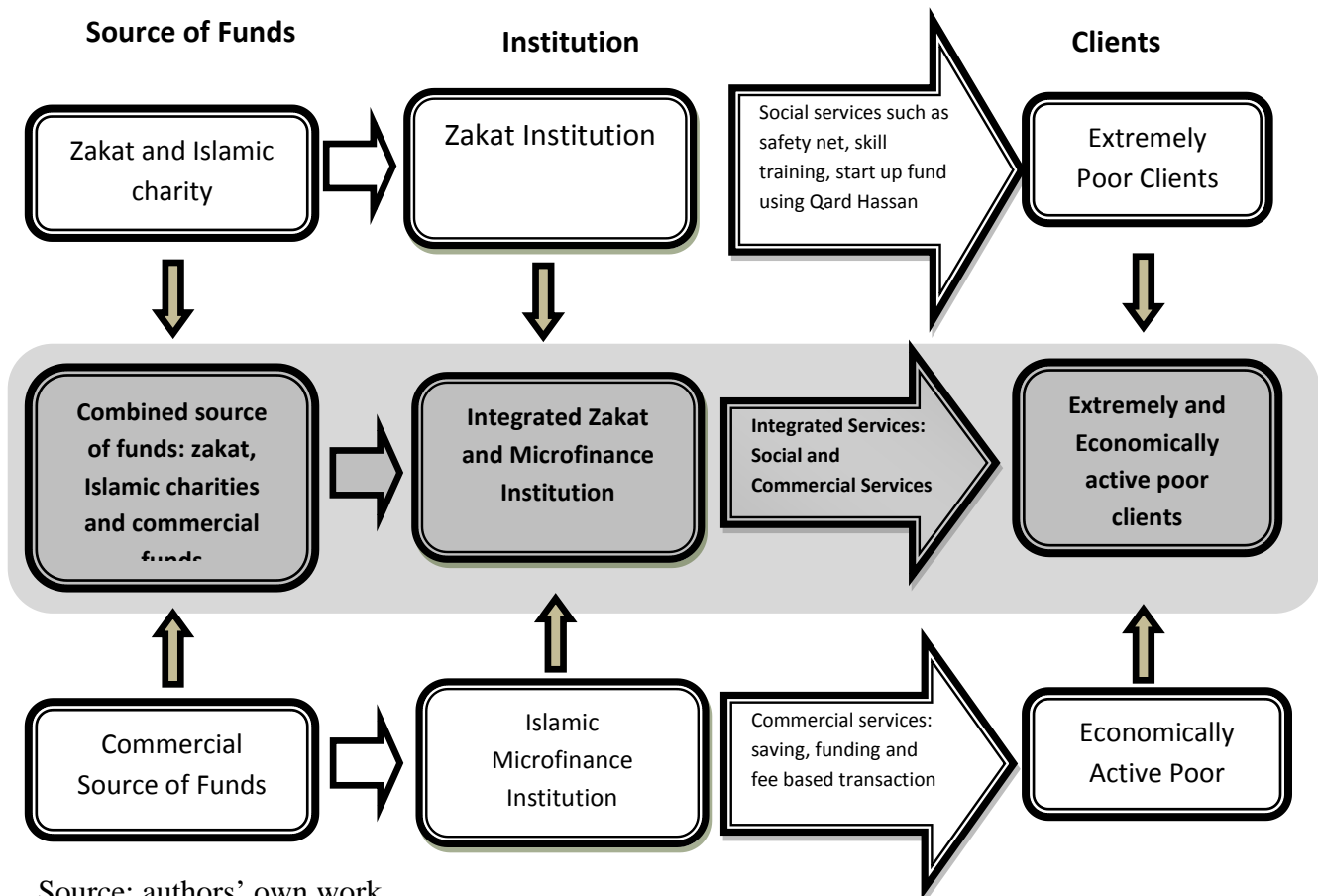
IV. The Integrated Model

Drawing on the unique aspects of Islamic finance principles for poverty alleviation, there is a scope for Islamic MFIs to have great success in the dual goals of financial sustainability and

wide outreach to the most in need by utilizing zakat and Islamic charities as an additional source of funds.

This model offers an integrated model of two institutions: the institution of *zakat* and Islamic charities with the institution of Islamic microfinance. The integrated institution is utilized combined source of funds: *zakat* and Islamic charities as well as the commercial source of funds. By using combined sources of funds, the institution could provide both commercial and social services for both extremely and economically active poor. The commercial services offer various financial services such as saving products, funding schemes and fee based product for the economically active poor of the population. Meanwhile, the social services are designed to improve the wellbeing of the extremely poor and to increase their capacities and capabilities in conducting productive activities. After having adequate skills, it is expected that some of the extremely poor can start a new microenterprise and escalate to the wealthier group of the poor.

Figure 1: Integrated Model



Source: authors' own work.

The issue raised in this model is form of the integrated institution. Under the context of Indonesia, the integrated institution might be developed into two types of institutions: zakat institution with microfinance as its empowerment program and/or Baitul Maal wat Tamwil (BMT). One of the examples presented in case study in the next section is microfinance program

of Baitul Qiradh BAZNAS. Originally, BAZNAS is zakat institution in Indonesia, then, its microfinance program is developed to be its strategic business unit (SBU) with can independently managed its business. The second form is very famous in Indonesia, which is Baitul Maal Wat Tamwil (BMT). BMT is operated under supervision and regulation of Cooperative Department of Indonesia. Like the formal rural bank, BMT in Indonesia has opportunity in mobilizing funds through offering saving to the public and offering credit product for their clients.

The advantages of the model are:

1. Providing adequate services for the extremely poor clients and lift some of them to the economically active poor clients
2. It is possible to create a sustainable microfinance since it does not only depend on the donor fund to provide the microfinance. Having a license as regulated microfinance, the institution might offer various financial services including provision of saving, credit and other fee based financing services.
3. It increases the accountability of the both institutions since they need to report to *zakat* and Islamic charities payers and its potential payers, *sharia* compliance finance as well as the microfinance institution supervisory board.
4. It will create sustainable microfinance with lower default rate and reduce the possibility of misuse of the loans since the microcredit is only for the skilled people who conduct some income generating activities.
5. It will reduce the agency problems since both institution engage in the same value and objectives.
6. It will solve the debate of best practice of microfinance by *welfarist* and *institutionist* school. In one side, the institution will use the donor funds as the supporting funds of non investment activities and in other side it will become a commercial microfinance that may obtain source of funds from the commercial market.

V. The case study of the existence programs

The implementation of the application of Islamic finance in the microfinance practice has been started widely in the last decade. Indonesia is the representative laboratory of this application. As the biggest Muslim population in the world, the application of Islamic finance is widely applied in Indonesia to meet the high demand of Islamic financial services. In term of market share, the Islamic finance in Indonesia is less than three percent of the total market. However it has reached high outreach in rural areas consisting of 10 Islamic banks, 23 syaria units of commercial bank, 145 Islamic rural banks and thousand Islamic cooperative units (Karim, 2010).

Two programs will be discussed: the economic empowerment program of Baitul Maal Muamalat Indonesia (BMMI) and Baitul Qiradh of Badan Amil Zakat Nasional. Both program focus on the microfinance initiative and utilize *zakat* and Islamic charities as source of fund for microfinance practice. The major difference between them is Baitul Qiradh has moved ahead by developing microfinance project as strategic business unit which requires formal regulation as Islamic microfinance.

Baitul Maal Muamalat Indonesia (BMMI)

Baitul Maal Muamalat Indonesia (BMMI) is licensed *zakat* organization in Indonesia that can collect Islamic charities (*zakat*, *shadaqa* and *waqf*) and disburse the funds for the society purposes. BMMI has been engaged in various projects including education, emergency aids for natural disaster, and direct support for the poor as well as economic empowerment programs.

As social organization that focusing in economic empowerment, BMMI has built partnership with various organization including Islamic Development Bank, Ford Foundation and several commercial institutions such as PT Telkom Indonesia and Newmont Indonesia. Their main sources of fund to finance all the programs are various Islamic charities including *zakat*, *shadaqa* and *waqf* and donor funds from their partners.

The economic empowerment program of BMMI is named Komunitas Usaha Mikro Muamalat Berbasis Masjid (KUMMM) – Muamalat Micro Entrepreneur Community Based on Mosque. This program is designed to provide revolving working capital credit for low income micro entrepreneurs who actively participating in Mosque's activities. This program is supported by continuous technical assistants, mentoring and monitoring as well as formation of group support system.

The philosophic background of this program is integrating the economic empowerment with developing religious belief of the society. Three basic principles of this program are *zakat* disbursement for the eligible targets based on *Sharia*, building religious capacity of the *zakat* recipient, encouraging *zakat* recipient to develop business with modern management system.

Recently, KUMMM has served 4697 low income-micro entrepreneurs based on 185 Mosques in 24 major cities in Indonesia. Total fund disbursed is approximately US\$ 1,069 million. This number is very low comparing with many potential clients to be served. The data from Religious Affair of Indonesian Government shows that in 2004 the number of Mosques in Indonesia is 643.834. From the brief survey of BMMI, only 4 out of 100 Mosques are concerned with the economic empowerment of their society. KUMMM encourages Mosques to take part in this program by providing revolving working capital credit for street vendors, peddlers and hawkers who conduct trading in surrounding the Mosques. The credit recipients will get the revolving credit approximately US\$75 to US\$200 three times under non-interest free loan or it is called Qard Al Hassan to develop their business. The following credit will be given when the loan repayment is made.

KUMMM is the initial program of economic empowerment of BMMI. The management of BMMI has developed a blue print for the expansion of the program to be formal microfinance institutions. In the first phase, the program is only financed by *zakat* and Islamic charity to provide Qard Hassan loan for the low income people who are not bankable. The second phase, BMMI will provide credit for micro entrepreneurs who has asset less than IDR 50 million using profit loss sharing mechanism. In this step the program will be financed either by Islamic charities or profit loss sharing mechanism. The further phases, the institutions will be more commercial by offering not only credit but also saving products. Funds generated from saving can be used as alternative source of financing. Each phase will run in three year. However, in practice, they only depend on *zakat* and Islamic charities as program's funding. By implementing

this approach, the program is expected to support the microfinance program by the same time increase the religious belief of the society

Baitul Qiradh of Badan Amil Zakat Nasional

Badan Amil Zakat Nasional (BAZNAS) is *zakat* organization owned by the Indonesian government. As the social organization, BAZNAS has created several programs including education, health, economic and aid for natural disaster.

Indonesia Makmur is the economic empowerment programs that utilizing *zakat* and Islamic charities as the only source of fund to assist the poor people in the agriculture, veterinary, and fishery sector. BAZNAS offer Qard Hassan scheme of financing and provide technical assistant for conducting small enterprises in several areas in Indonesia including Nusa Tenggara Barat, Nusa Tenggara Timur, West Sumatra and West Java.

Moving forward in their economic empowerment program, BAZNAS has built a partnership with BMT ONE, who has been engaged in Islamic finance in Indonesia for more than 20 years to develop strategic business unit in microfinance initiative which is known as Baitul Qiradh. Baitul Qiradh aims to assist the poor people in improving welfare by providing loan under Qard Hassan mechanism as well as profit loss sharing financing. The source of fund to provide Qard Hassan loan is *zakat* and Islamic charities, while the institution also offers saving and financing product under profit loss sharing mechanism.

Recently, BAZNAS and BMT ONE have developed three Baitul Qiradh in Indonesia which on average their asset valued at US\$ 250,000 to 860,000. Baitul Qiradh Baiturahman is one of the Baitul Qiradh's branches that located in Aceh province. The institution has assisted many poor people in Aceh after tsunami disaster in 2008. Their target clients are micro-trader, micro-entrepreneur and informal sector especially in surrounding Ulee kareng market. They provide various saving products under mudharabah and wadiah mechanism as well as financing product under mudarabah, murabahah, bai bisaman ajil and ijarah schemes. Its financing is ranging from US\$50 to 750 which can be installed in 6 month to 3 years.

In addition, 20 Baitul Maal have been developed in Jogjakarta and East Java province. Baitul Qiradh has implemented modern management system with integrated technology and online transaction in all their branches in Indonesia using BAZNAS card thus all transaction can be done in all areas in Indonesia. Utilizing both Islamic charity and commercial funds may facilitate Baitul Qiradh to increase their outreach in many areas in Indonesia

VI. Evaluating the existence programs

Learning from the existence programs of BMMI and Baitul Qiradh Baznas, we may draw an evaluation of these programs based on the theory of microfinance and Islamic finance from several dimensions: their target clients, their sources of financing and their product and lending schemes as summarize below:

Table 2: Evaluation of existence programs

Program	KUMMM of BMMI	Baitul Qiradh BAZNAS
Target clients	Street vendors, peddlers hawkers and micro-entrepreneurs surrounding the Mosques	Poor in the agriculture, veterinary and fishery sector
Source of fund	Zakat and Islamic charities	Zakat, Islamic charities and commercial source of funds
Products and Lending Scheme	Qard Hassan loan	Qard Hassan loan, saving and financing under mudarabah and murabahah scheme
Loan disbursed	US\$ 1,069 million	More than US\$0.5 million ⁱⁱ

Source: authors' own work

The target clients

The central debate of the microfinance practice now is whether the program has reached the very poor group of the population. As noted by Robinson (2001), microfinance is suitable tool of poverty reduction for the economic active poor. This idea is supported by Hulme and Mosley (1996) who state that the successful microfinance contributing to poverty reduction are particularly effective in improving the status of middle and upper segment of the poor. However, clients below the poverty line were worse off after borrowing.

Both programs offered by BMMI and Baitul Qiradh BAZNAS are only targeted poor/low income clients who have some forms of employment or skills in conducting microenterprises. BMMI for example, focuses their program only for the street vendors, peddlers and hawkers in surrounding the Mosques. Ahmed (2002) notes that one reason the extremely poor has been left out is they usually divert the funds received for the consumption purposes rather than productive activities. Furthermore, the extremely poor who has lack of skill only generates lowest investment return which make them difficult to repay the loan. Ideally, economic empowerment program provides training and skill development to equip the poorest of the poor to take part in income generating activities. Here, *zakat* and other form of Islamic charities can be used as alternative financing to provide training and skill development of the extremely poor, therefore after having adequate skill, it is expected that some of the extremely poor can shift to the higher group of the poor - the economic active poor group who are most targeted by microfinance (Obaidullah, 2008).

The source of funds

The KUMMM of BMMI in Indonesia and the Baitul Qiradh BAZNAS have been integrated the used of Islamic charities and microfinance in the purpose of economic empowerment and poverty alleviation. BMMI microfinance initiative only utilizes funds from the Islamic charities to finance its operation. The major issue in utilizing *zakat*, *awqaf* and *shadaqa* as financing sources in microfinance is its uncertainty of the amount of fund being mobilized (Obaidullah, 2008). The funds have been fluctuated from time to time since it is purely voluntary and only depend on the willingness of Moslem in paying charity. Evaluating this practice based on the microfinance theory, this program is based on the old paradigm of the *welfarist* school, where donor funds is the only funding of microfinance. Donor funds here refer to the Islamic charities including *zakat*, *awqaf* and *shadaqa*. Depending only on this type of funding will not create a

sustainable microfinance with sounding financial performance and high depth of outreach. In Islamic perspective, the main function of *zakat* and other Islamic charities is for assuring the poor in fulfilling their basic material necessities of life and be functioning as safety net for the poor.

However, the future plan of BMMI will combine several sources of financing: the Islamic charities, public saving, return from funding services. In fact, the implementation of the program now is still using *zakat* and other Islamic charities as the only source of financing. It is argue that the low number of clients have been now is due to lack of source of financing.

Baitul Qiradh as strategic business unit of BAZNAS and BMT ONE has built into formal Islamic microfinance that combined *zakat* and Islamic charities as well as mobilizing funds through public saving and generating income through profit loss sharing mechanism. Baitul Qiradh has been developed into commercial institution by integrating its system in all branches in Indonesia. This practice has adopted the *institutionist* view that to serve large number of clients the institution has to be financial sustainable and cannot depend to the donor funds in the long run.

Product and lending scheme of the program

Another similarity of KUMMM BMMI and Baitul Qiradh BAZNAS is providing the non interest loan scheme for the target clients. This mechanism is called Qard Hassan which is a kind of loan returned at the end of the agreed period without any interest or share in the profit or loss of the business (Chapra, 1995). In narrow perspective, the objectives of this scheme are to help the poor and to establish a better relationship between the poor and the rich. While, in broader perspective, the implementation of Qard Hassan encourage the wealth transfer, increase the money supply and reduce the poverty by providing facility for the poor to create employment and business venture.

In Qard Hassan scheme any extra amount of loan is considered as *riba* (usury). This scheme provides no profit for the institutions. However, service and management fee is lawful in Islam (Wilson, 2007). Islamic banks usually charge 2-3% of service fee additional to the loan. As charitable loan, Qard Hassan is design for personal loan of the needy. Microfinance practice is very high cost. Ayayi and Sene (2010) argue that microfinance institution can create its sustainability by charging adequate interest spreads and by practicing secure loan management. Since interest is prohibited in Islam, it is suggested that instead only offering Qard Hassan, microfinance practice should establish profitable Islamic scheme of transaction to finance the project such murabahah and PLS schemes.

Baitul Qiradh BAZNAS as the Islamic microfinance institution has offered various Islamic scheme of transaction such as mudharabah and murabahah in various products of saving, financing and long term investment under PLS mechanism. The implementation of PLS enable the institutions to create more commercial microfinance that transform form non-profit organization to formal Islamic microfinance institutions. This institution is allowed to offer both saving and credit products to the poor. By transforming from non-profit organization into formal financial institution, MFIs might access diversified source of funds and reduce the possibility of liquidity shortage (Champion and White 2001). Therefore, MFIs can grow continuously and meet the increasing demand for loan. Additionally by offering saving services, MFIs can expand

its client base and serve its social objective by providing financial services for large number of low income clients. Share the same arguments, Claudill et al (2009) argue that commercialization has positive impact on increasing the efficiency of MFIs. Their study shows that MFIs that more reliant on subsidy are less efficient than those who are depend on deposit and less reliant on subsidy donor.

To sum up, economic empowerment program offered by BMMI has been integrated the use of *zakat* and other Islamic charities for microfinance by offering non-interest loan or Qard Hassan for micro entrepreneur based on Mosques in Indonesia. However, in regard to the issue of sustainability, it is suggested that the program should offer various products under profit loss sharing mechanism. Therefore, *zakat* and Islamic charities can be performed only for providing non-profitable services for the extremely poor.

The second program, Baitul Qiradh is an example of integrated institution of *zakat* and Islamic charities with the microfinance initiative. As strategic business unit of BAZNAS, Baitul Qiradh has developed into formal Islamic microfinance institution under license as BMT. As formal institution, they could offer both saving and credit products by implementing Islamic schemes of transaction. Additionally, the institution also provide Qard Hassan loan using *zakat* and Islamic charities as the source of fund.

However, since the basic function of *zakat* and Islamic charities is to create the equal distribution of income in the society, both institutions are expected to target not only the economically active poor but also the extremely poor clients. To be successful in the poverty alleviation, microfinance has to be supported by non-financial services along with financial services. The combination of commercial funds and non-interest funds in microfinance will be beneficial to serve wide outreach and achieve sustainability.

VII. Conclusion

Microfinance initiative has evolved over the past four decades as important poverty reduction mechanisms. There is strong evidence however to suggest that increasing their financial sustainability often constrains their ability to reach the poorest of the poor. This paper considered how Islamic religious beliefs around social inequality can provide a constitutive force for poverty reduction. Specifically, this paper considered how Islamic principles of finance and charitable obligations (including *zakat*) can be integrated into the operations of a microfinance institution in order to enhance financial sustainability of the organization but more importantly to enhance poverty alleviation outcomes achieved by the organization. By integrating Islamic financial principles and microfinance activities with Islamic charity, this paper has shown it is possible to pursue the dual objective of increasing outreach and enhancing sustainability and try to solve the debate between *institutionist* and *welfarist* view in microfinance initiative. In this regard, this paper adds to the small but increasing important literature calling for the more explicit recognition of the value of religion, religious belief, and religious organizations within development.

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List of Abbreviations

BAZNAS	: Badan Amil Zakat Nasional is Indonesian government owned zakat institution.
BMMI	: Baitul Maal Muamalat Indonesia is licensed zakat institution. In Indonesia, the organization that can collect zakat and Islamic charity has to obtain a license from the government as zakat institution
BMT	: Baitul Maal wat Tamwil is Islamic microfinance under licensed as Islamic financial cooperative
BRI	: Bank Rakyat Indonesia, one of Indonesian state owned bank
CGAP	: The Consultative Group to Assist the Poor, the organization that promotes microfinance practice worldwide under The World Bank sponsor
KUMMM	: Komunitas Usaha Mikro Mumalat berbasis Masjid, economic empowerment program of BMMI that providing revolving working capital for micro-entrepreneur in surrounding Mosques in Indonesia
MFI	: Microfinance Institution
PLS	: Profit Loss Sharing scheme of financing in Islamic finance

ⁱ Data is collected and analyzed by FEM Institut Pertanian Bogor Indonesia 2011

ⁱⁱ Only based on Baitul Qiradh Baitur Rahman Aceh