



ZAKAH AS AN ISLAMIC MICRO-FINANCING MECHANISM TO PRODUCTIVE ZAKAH RECIPIENTS

Patmawati Ibrahim

*Senior Lecturer, Faculty of Technology Management and Business, Universiti Tun Hussein Onn Malaysia,
Johor, Malaysia*

Ruziah Ghazali

General Manager, Nordant Management, Taman Sri Bt Caves, Selangor, Malaysia

ABSTRACT

There are various forms of zakah distribution practiced by the zakah institutions. One of them is the distribution of zakah in a form of business capital given to productive zakah recipients. This form of zakah distribution is recognized as micro-financing mechanism. Thus, this paper attempts to analyse the potential of zakah fund as a source of Islamic micro financing to productive zakah recipients. The analysis is divided into several parts. Firstly, this paper discusses on the rationale of zakah fund as a source of micro financing to small Muslim entrepreneurs. It is then followed by the feasibility study of zakah as a micro financing mechanism. Thirdly, this paper shares the practicality analysis of the mechanism by sharing the experience of Selangor Zakah Board (Lembaga Zakat Selangor - LZS). In addition, it also highlights the problems and challenges of LZS in performing the role of 'micro-finance institution'. Lastly, suggestion on the proper mechanism of zakah micro financing to ensure its effectiveness is given in the final part of the paper. This is to ensure that the objectives of zakah in alleviating poverty and reducing income inequality are met.

Keywords: Economic development, Islamic economics, Zakah, Micro-finance, Poverty, Income distribution

JEL classifications: R51, Z12, G21, I3

1. INTRODUCTION

The most precious resource in the world is people (i.e. human resource) and their potential to work for the collective betterment of their society. Poverty, due to income inequality put these resources and their potential to waste. The socio-economic system of Islam has, from the very outset addressed the problem of poverty in a comprehensive and pragmatic way. It is indeed unique to Islam to include the zakah payment as a pillar of Islam, and make the first two of the

eight beneficiaries of zakah, the *fuqara* and *masakin*, in that order. This clearly shows how commitment Islam is in combating poverty and income inequality, and the potential of zakah institution in increasing the welfare of the society (Ataul-Huq, 1990).

One most basic question in financial economics is how businesses get financing to fund their operations. There are two main sources for businesses to raise finance which are internal and external. Major internal sources include retained earnings, while the major external sources include loan from financial institutions like banks, and equity finance through the sale of shares (Kashif Imran and Samina Khalil, 2012). Microfinance is the practice of making loans to poor people to help them rise from poverty through entrepreneurship. It is usually defined as the provision of financial services and products to those whose low economic standing excludes them from conventional financial institutions or programmes. Apart from converting dead capital into income generating assets, microfinance actually functioned as the blood of the poor, an engine to stimulate the potential of the poor, who are inactive due to unavailability of capital. People living in poverty like everyone else, need a diverse range of financial services; run their businesses, build assets, ensure smooth consumption and manage risks. These can include microcredit, small scale venture capital, savings and some forms of insurance. Microfinance offers poor people access to basic financial services such as loans, savings, money transfer services and micro insurance. A small loan allows a person with a start-up capital necessary to make something small to sell. Poor people usually address their need for financial services through a variety of financial relationships, mostly through informal networks. A study in south western Nigeria for example, revealed that informal rural households banking methods is the most preferred banking methods by the rural households (Gabriel, 2011).

2. THEORETICAL OVERVIEW: FEASIBILITY AND PRACTICALITY OF ZAKAH AS MICROFINANCE MECHANISM

A large number of studies on poverty indicate that exclusion of the poor from the financial system is a major factor contributing to their inability to participate in the development process. High population growth rate and limited employment opportunities in the agricultural sector and the modern manufacturing sectors leave a vast majority of the labor force without productive employment. Microenterprises can play a significant role in employing the surplus labor force productively. Thus, growth in microenterprises or small enterprises can be important means for employment generation and development of poor countries. All this started with the availability of microfinance instruments in the society which have the potential to improve the economy and be socially responsible by helping people who are in desperate need of financial assistance, but have very few avenues to turn to. The conventional microfinance facilities however pose two major obstacles to the Muslim poor. The first obstacle is in the form of collateral requirement which is usually beyond their capabilities. The second obstacle is the religious injunctions against interest (*riba*). Therefore, Islamic alternatives to financing facilities must be put in place,

In Islam, there are several non-profit instruments of securing funds, such as, *Zakah*, *Sadaqah*, *Qard-Hasan* and *Awqaf*. These are all sources of funds for a microfinance mechanism and among the various forms of financial assistance that can be provided to the poor and needy Muslim to improve their socio-economic standard of living. This paper would focus on zakah as a mechanism for micro financing among the Muslim society, referred to as Zakah Micro Finance (ZMF). Ascertaining that ZMF can be demanding as well as profitable ventures, correct implementation of the intended instrument could give outstanding results.

In some countries, micro finance assistance to the poor and needy has been proven to be successful in helping them to overcome their economic problems. In Iran for example, a micro-financing scheme of *qardul hasan* (QardulHasan Micro Financing - QHMF) has successfully helped the farmers and small businessmen (Ahmad, 2004), while in Bangladesh, the informal micro finance loan schemes (Informal Micro Credit) has helped especially small business owners and street hawkers in urban areas with financial difficulties (Mannan, 2007).

However, financial resources used in Iran and Bangladesh in the above cases, did not come from zakah funds. The issue is, can zakah funds be used for micro credit loans? This issue has been in discussion for a long time. Government of Pakistan has raised the issue about the possibility of issuing interest-free loans to individuals who need to use zakah funds in 1950 (1369 AH). In answer to this question, Abu Zahrah (1951) had allowed it to be. He stated that if the borrower dies and his heirs cannot pay the debt, the debt can be paid using zakah funds. This means that Abu Zahrah allowing zakah funds to be used to provide interest-free loans to individuals in need. No worries about 'losing' zakah fund as a result of micro-credit as it is an interest free loan. This means that the fund (loan) will be paid back by the borrower. Should the borrower dies, the loan will be amortized using zakah funds from the provision of debtor (*asnaf Gharimin*). A study by Yusof (1973) revealed that both Imam Malik, Imam Shafi'i, and Imam Ahmad were of the opinion that the outstanding balance must be paid from the assets of the borrower. If inheritance is not enough, the unpaid debt would be (considered) bad debts. However, in Islam the debts due (fair debts), shall (be) solved using zakah funds

Yusof (1973), stressed that according to *qiyas* and the general purpose of Islamic teachings of zakah, loan is allowed to be given to the needy from the part of the debtors (*Gharimin*). To him, zakah can be practically used to combat usury and removing all the usurious aspects (*ribawi*). In other words, loans in the form of *qardul hassan* from zakah fund will prevent them from involving in a loan that consists the element of *riba*. Another argument is that if the debt can be paid from zakah fund, then more importantly, borrowing could be done from the zakah fund by way of a good and clean from the elements of *riba*. This is a major *qiyas* (*qiashul-aula*) (Yusof, 1973).

The same is also discussed in the First Seminar on the Management of Zakah in Modern Muslim Society in 1985. Shawki Ismail Shahatah (1989) proposed that in certain circumstances such as emergencies, natural disasters, health problems and expensive surgery, interest-free loans should be given to the needy. Such interest-free loans should also be extended to those who are in debt and is entitled for micro financing in accordance with Shariah requirements.

Thus, for the purpose of helping low-income earners and those in needs, especially as business capital, zakah could be used to provide financial assistance to the needy and poor in the form of soft loans or interest-free loans.

3. CASE STUDY: THE EXPERIENCE OF SELANGOR ZAKAH BOARD (LEMBAGA ZAKAT SELANGOR - LZS)

The management of zakah in Malaysia is put under the authority of the state. Since there are 14 states in Malaysia, matters pertaining to zakah are managed by the Islamic religious council in each state respectively. Selangor Zakah Board (*Lembaga Zakat Selangor - LZS*), is responsible for dealing with zakah management in the state of Selangor pertaining to the collection and distribution of zakah. LZS is one of the most efficient zakah management centre in Malaysia which always been an example and leader to the other zakah centres in Malaysia.

Apart from being classified according to the 8 *asnaf*¹, the zakah recipients in Selangor are also classified under two major categories of productive and non-productive zakah recipients according to their physical ability. For the able-bodied and healthy zakah recipients, they are categorized as productive zakah recipients, whereas the ill-health and elderly peoples are categorized as non-productive zakah recipients. The productive zakah recipients comprise of those who are able to work to meet their needs. However, the return is inadequate to fulfill the households' basic needs. This mean that their income is lower than the rate of *had al-kifayah*². This group usually consists of those who do not have any skills or semi-skilled. On the other hand, the unproductive group of zakah recipients refers to the elderly people, the ill-health and the disabled. They are not able to find their own income to fulfill their family basic needs.

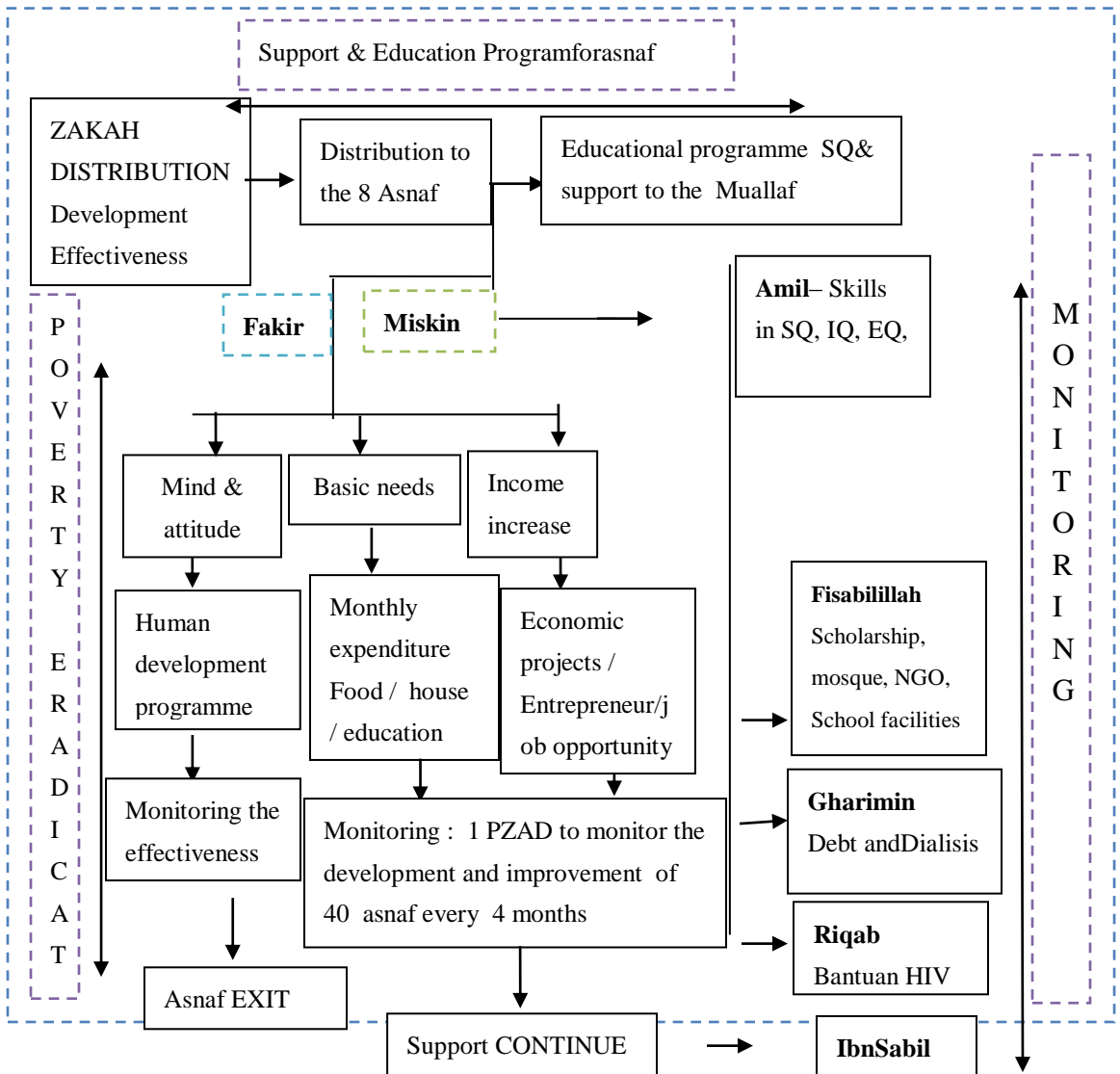
The distribution of zakah is classified according to the usage of the fund, either in the form of consumption or production. Consumptive zakah distribution is given continuously for consumption purposes for a relatively long period of time. It covers food, shelter, transportation, medicine and schooling expenses. This type of assistance is mainly given to the non-productive group. On the other hand, productive zakah distribution is given for production purposes to the recipients that are productive. This assistance has long-term goals as to improve their quality and standard of living. Zakah assistance will be given to recipients to finance their economic projects for a long-term production and survival purposes. In a long term period, they are expected to become self-reliant and productive and able to pay zakah in return. The assistance given to them will be stopped once they have reach this level. Unlike the consumptive assistance which is given continuously, productive assistance is given for a short period of time only. The main goal is for a productive and effective use of resources to eradicate poverty.

¹Asnaf is a category of peoples entitled for zakah distribution. There are 8 groups of people that are entitled for zakah distribution namely the hardcore poor (*faqir*), poor (*miskin*), zakah collector (*amil*), newly converted Muslim (*muallaf*), the slaves who have been promised to be freed by the master by paying certain amount of money (*riqab*), the debtor (*gharim*), in the way of Allah (*fi sabilillah*) and the wayfarer (*ibnusabil*).

²*Had al-kifayah* is the value of total household's basic needs.

The following chart 1 summarizes the process of zakah distribution to the 8 groups of zakah recipients (*asnaf*) in Selangor. The main objective of the whole program is poverty eradication. Three basic focus of zakah assistance are for the improvement of mind and attitude, fulfilling basic needs, and income increase. The focus on income increment would involve economics projects to enable recipients to become entrepreneur and create job opportunities to others as well. This is where zakah distribution is given in the form of capital to finance the economic projects of the productive zakah recipients. In this study, this type of distribution would be called as Zakah Micro Finance (ZMF). Monitoring will be done throughout the distribution process. If the economic project grant turns to be a success, the recipients will exit from the zakah distribution system. Otherwise the support will continue.

Chart-1. Flow chart of the distribution of zakah fund as an instrument for poverty eradication



Source: Zakah Training Centre, Selangor Zakah Board, 2011

Note: SQ: Spiritual Quotient IQ: Intelligent Quotient EQ : Emotional Quotient
PZAD: District Zakah Officer

There are two categories of ZMF recipients in this zakah distribution system:

- 1) ZMF given to entitled zakah recipients (*asnaf*) especially from the hardcore poor (*faqir*) and the poor (*miskin*) categories to start a business. For this category, they do not have to repay the ZMF given to them.
- 2) ZMF given in term of soft-loan (*qardhul hasan*). This is a short term interest free loan given to the applicants who are in desperate need of loan. These applicants are expected to be able to recover and solve their business problem if ZMF assistance is given to them. For this category, they have to repay the ZMF advanced to them. As compared to the first category of ZMF, this program is very new to LZS and hence still under the trial period or probation period.

The focus of ZMF assistance in Selangor is on the first category. LZS has planned an entrepreneurial program as an economic development program for the poor and hardcore poor. It is conducted by LZS as a way out to tackle poverty. This is akin to fishing, where they not only give the poor and needy the mean to be lucrative, but also educate them to become successful in the world and hereafter. In a way, it does not only help to reduce poverty but also help to develop human capital. Poverty cannot be solved by providing material assistance and money alone.

LZS has outlined the following procedures in the implementation of ZMF :

- i. Provision of initial capital and additional capital are for potential business project.
- ii. Each recipient's background and his/her motivation will be examined. The selection process is a rigorous evaluation as the LZS wants to ensure that only those truly eligible are selected. Eligibility here means having skills, business interest and desire to learn as well as having the physical capabilities.
- iii. Provide knowledge and guidance to the recipients before and during the conduct of business.
- iv. The capital is given in the form of equipment and working capital such as machinery and rental premises.
- v. The ZMF recipients are of small scale and medium-scale businesses.
- vi. Each recipient will be given a basic course of business, including financial management and motivation before starting a business. For the medium scale business, LZS will provide more exclusive guidance and monitoring.
- vii. LZS would provide spiritual knowledge and religious practices to instill praise worthy (*mahmudah*) attributes such as trust, honesty, sincerity, and so on and to avoid negative (*mazmumah*) attributes.

In addition, the LZS also established Asnaf Zakah Entrepreneurs Group (*Kumpulan*

Usahawan Asnaf Zakah - KUAZ) which consists of those who have received ZMF capital assistance from LZS. By KUAZ, LZS acts to monitor and protect the interests of the members and help to promote and market their products.

3.1 Monitoring Program of LZS Entrepreneurs

LZS has organized the monitoring program for the ZMF recipients. In this program, one zakah officer is responsible to monitor 40 recipients on quarterly basis to see the progress and development of the business project. This monitoring also includes other aspects of life such as spiritual aspects, daily necessities, housing conditions and income. The LZS officer will update the status continuously to ensure that more appropriate and productive measures could be done faster.

3.2 Performance of ZMF Implementation by LZS

Realizing the potential of ZMF to bring the people out of poverty as experienced by Iran and Bangladesh, LZS has increased the allocation for ZMF capital. The figures shown in table 1 illustrate an increasing trend in the number of recipients from 343 people in 2008, to 435 in 2010. The total amount of capital distribution also rises from RM1.8 million in 2008, to RM 2.4 million in 2010. Average distribution per recipient is also increasing from RM5267.5 in 2008 to RM9398.02 in 2009. Average distribution is declining in 2010 to RM 5660.53 per recipient. This is due to reduction in LZS allocation coupled with increasing number of recipients. However, these figures are for the first category of ZMF recipients only.

Table-1. Total ZMF Distribution to the First Category (*faqir and miskin*) (2008-2010)

Programme	Number Of Recipients			Total
	2008	2009	2010	2008 – 2010
Business Capital Assistance	299	234	356	889
Fishery Capital Assistance	21	8	50	79
Livestock Capital Assistance	8	12	11	31
Agricultural Capital Assistance	15	22	18	55
Total Recipient	343	276	435	1054
Total Distribution (RM)	1,806,753.	2,593,854	2,462,331	6,862,938
Average amount of distribution per recipient	5,267.50	9,398.02	5,660.53	6,511.33

Source: (Unit, 2008 – 2010) R&D unit, LZS (unpublished)

There is no official record on the performance of the ZMF recipients. However, it is informed by the then General Manager of LZS that the successful rate of ZMF entrepreneurs is less than 30% (Patmawati, 2009). This performance is low in comparison to the other micro-finance institutions in Malaysia, such as Amanah Ikhtiar Malaysia (Matthew, 2010).

4. SUGGESTION AND CONCLUSION

There are various factors contributing to the low successful rate of ZMF. The authors have identified the following factors that could be considered critical for an effective implementation of Zakah as an instrument for Islamic microfinance:

1. Proper mechanism.

There should be a proper mechanism in place in ZMF implementation. For example, there must be a proper agreement between the zakah institution and the ZMF recipients to hinder any irresponsible recipient.

2. Monitoring procedure.

There should be a proper monitoring procedure by the zakah institution. Effective monitoring will ensure feedbacks are given and corrective actions are done before problems became acute. Thus, monitoring should be on a continuous basis. A proper monitoring would also be a motivation to the ZMF recipients as they know that their performance is being monitored. A good monitoring procedure will produce a highly motivated and committed participant.

3. Impact assessment

There should be an impact assessment procedure taken by the zakah institution to measure the success of ZMF recipients. This mechanism will be helpful for the zakah institution to make a decision of whether the ZMF assistance should be continued or discontinued by assessing the current performance as well as to predict future growth of the ZMF entrepreneurs.

In conclusion, micro finance is very important to the poor. ZMF methodology is closer to the community. Being an interest free and non-financial services which are free of charge, a proper mechanism of ZMF can help the hardcore poor and the poor in encouraging them to give maximum efforts for the development of their qualities of life towards poverty alleviation.

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