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The Role of Islamic Micro-finance in Enhancing Human Development in Muslim Countries

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Abstract

Human development and human welfare are important ends in Islamic economic development, and hence the need to focus on a broader approach, in evaluating the condition of people in society. In Muslim societies, poverty is still pervasive partly due to the poor have been excluded from the financial system. The main objective of this study is to explore the conceptual framework on the role of Islamic micro-finance in improving human development. The methodology of this study is based on analysis of relevant documents. The findings of the study indicate that Islamic micro-finance is a growing market niche with a comprehensive approach towards human empowerment, increased income and well-being. The income generated by the clients is utilized to improve health conditions and the educational level of children. Zakat and Awqaf institutions are regaining their momentum towards socio-economic relevance. These institutions are requisite for generating community assets, productive capacity building, wealth creation and knowledge and skills that will enhance the technical standing of entrepreneurs. This approach towards financial inclusion could bring improvements in human capital development, education and skills development, better provision of physical capital and wider access to micro-credit for the productive poor.

Keywords: Islamic micro-finance, Human development, Zakat, Awqaf

1. Introduction

The challenge of poverty is real despite the efforts to contain it by nations. The World Bank defines extreme poverty as living on less than US$1.25 per day, while moderate poverty as living on less than $2 a day (World Bank, 2008). The proportion of the developing world's population living in extreme economic poverty has fallen with much of the improvement occurred in East and South Asia. In Muslim countries, the poverty rate is equally high with the exception of south East Asian nations and the Middle East. Accounting for about a quarter of world population, the 57 member Organization of Islamic Conference (OIC) produced only 10.9 per cent of the world total GDP (Rahman, 2013). The devastating socio-economic and political consequences of this problem are increasingly evident in Muslim countries, especially regarding the vulnerable groups, such as rural dwellers, widows, those whom are sick, the aged, orphaned children, the landless and physically challenged (Raimi, 2013). The major objective of economic growth is to deliver economic well-being and quality of life, and yet the debate rages as to what extent does economic growth reduces poverty. It is noteworthy that economic growth is expected to automatically trickle-down and spread its benefits across society, yet the predicament of the poor persists even with high economic growth. Roemer & Gugerty (1997) and Gallup, Radelet & Warner (1998) have argued that economic growth appears to be one of the best ways to reduce poverty since it brings opportunities for investment and job creation. These opportunities translate into increased employment and productivity that lead to increase in average income. Nevertheless, a sizeable chunk of the global population continues to languish in abject poverty owing to limited opportunities, low levels of education, inadequate health and nutrition. This result in much of the poor working as subsistence farmers or in insecure, informal employment that generate low incomes and perpetuate the state of poverty (Farrigan and Parker, 2012). Such situations hinders the poor from gaining employment opportunities, establish markets and gain access to capital and could thus impede human progress and development (Gallup *et al*., 1998; Foster and Székely, 2001). Employment in insecure and low paid jobs that is not supported by improvements in productivity result in the rise in the number of working poor but not necessarily improving the quality of labour. A meaningful quantitative and qualitative change lays in improving the potential of the mass of population through education, health and work place conditions. It is noteworthy that the impact of economic growth is essential in creating opportunities and raising the standard of living and in fact is one of many conditions for poverty reduction. However, it will requires a decisive policy stance to promote the economic and social well-being of the people through the development of human capital, critical infrastructure, social inclusion, health, and literacy. Economic growth can potentially play a central role in human development, poverty reduction and the achievement of the Millennium Development Goals. To promote a balanced and equitable growth there is the need to have the poorer sections of the society to participate meaningfully in the economy (Mohieldin *et al.*, 2011). Financial exclusion of the poor and their inability to secure employment owing to poor educational levels are the major factors that have denied them to make a meaningful contribution to national development. Lack of collateral has alienated a significant part of the society perceived as un-bankable and has deterred them from human and capital development necessary to get out of poverty. Financial inclusion through micro-finance has been reported to improve the living conditions of the poor. It avails them the opportunity for income generation, productivity, capacity building and as well contribute to economic development process and overall national development (GIFR, 2012). According to Rahman (2013), micro-finance organizations target micro-employment and grass-root economic activities such as agriculture, horticulture, cattle rearing and micro-enterprises and support products that lead to industrial clusters.

2. Islamic Micro-finance

Poverty is multidimensional and therefore requires different approaches in order to tackle it. The Millennium Development Goals (MDGs) 2015 report revealed that, globally, the number of people living in extreme poverty has declined significantly from 1.9 billion in 1990 to 836 million in 2015, while the number of people in the working middle class (living on more than $4 a day) has almost tripled between 1991 and 2015. This justifies the huge budgets for the fight against poverty. The international commitment for MDGs in 2005 was essential in the global fight against poverty. This could be seen in the way it called for new thinking to develop strategies to attack the multifaceted dimensions of poverty. Diverse stakeholders from donor agencies, NGOs, private investments and the support from governments addressed the challenge of poverty. The central focus of this strategy was to enable the poor people to generate income, build assets or attain an educational level necessary to get out of poverty. For the poor, the prospect of getting out of poverty was difficult since financial institutions perceived them as un-bankable for their inability to own collateral security, and possessing a lower human capacity (GIFR, 2012). Micro-finance emerged as an economic development approach targeting that segment of the society that is financially excluded. Notably, the Grameen Bank model by Dr. Mohammed Yunus in the late 1970s was instrumental in the development of micro-finance. The Grameen Bank model is based on the premise that, even without collateral, microloans can be extended, and the poor people can equally be productive if given the requisite funding. The target was rural poor households and adopted a group-lending method that emphasised joint liability among the group members (Omar, Noor & Dahalan, 2012). The group-lending method enabled Grameen bank to have higher repayment rates than similar credit programs using other conventional lending practices (Dusuki, 2006). That experiment was able to engage the poor in productive activities requisite for income generation and secure a better standard of living. It also led to deposit mobilization especially in the rural areas and promoted socio-economic goals of the society. They were offered minimum banking services at a reasonable cost, with minimum documentation and simple loan procedures. Furthermore, financial literacy, business advisory courses to develop skills that are required to run a successful enterprise. Despite the many challenges of the poor, several studies have commend the role played by micro-finance institutions in meeting the financial needs of the deprived groups in the society (Akhter, Akhtar and Jaffri, 2009). Researchers have shown that institutional innovation is significantly influenced by culture, technology and working process (Tasmin and Woods, 2007). Hence, micro-finance is a form of service, which could be significantly shaped or moulded by culture, the way Muslim practice their way of life, especially in dealing with financial transactions.

Islamic micro-finance is an innovation in micro-finance to attract ethical consideration in line with the dictates of Islam in doing business. This is essential owing to the fact that conventional micro-finance does not meet with the expectations of Muslims in accordance with their faith (Akhter *et al*., 2009). Islamic micro-finance is an offshoot of Islamic finance, which has its foundation imbedded in the Quran and Sunnah (teachings of Prophet Muhammad, peace be upon him). Islamic finance aims to promote trade based on profit and loss sharing and prohibition of interest, speculation and uncertainty in business transaction (Bhuiyan *et al*., 2011). Islamic micro-finance evolved as a market niche offered to the less privileged. It seeks to provide financial mediation for the factors of production, in producing goods and services through profit and loss, leasing and sale with emphasis on ethical and moral values in business (Kahf, 2007). The provisions by Islamic law (*Shari'ah*) that prohibit interest, speculation and uncertainty in business transactions are the key issues that distinguish Islamic micro-finance from the conventional micro-finance (Onakoya and Onakoya, 2013). It is built upon the concept of Islamic social justice that disallows exploitation but encourages charity to the less privileged in the society. It uses profit and loss sharing (PLS) arrangement in business because of the belief that it leads to more efficient resource allocation between the entrepreneur and the financier (Rahman and Rahim 2007). The risk that the commercial banks and other conventional financial institutions evade, is shared between the financier and entrepreneur under the PLS arrangement. It mobilizes funds, investments and employment opportunities as well as growth to fulfil the basic needs of the poor and hence fight poverty (Kahf, 2007). Advocates of this type of finance argue that profit and loss sharing (PLS) leads to equitable distribution of income, more control and efficient resource allocation. The Islamic micro-finance experiment has brought a positive attitude for development, in providing benefits to one another and has created real value in improving the standard of living.

GIFR (2012) has grouped the Islamic micro-finance products into three (3), namely: micro-credit, micro-equity and charity. The micro-credit entails the usage of business asset based on loan or lease. One of the considerations for this idea is a lack of capital in the face of a business opportunity. Micro-equity enables a business relationship when one party provide the capital while the other party manages the business. In micro-equity, factors of production are brought together while profit/loss is shared in line with agreed upon formulae. The charity aspect of Islamic micro-finance serves as a source of additional empowerment in the form of safety nets and for sustainability motives.

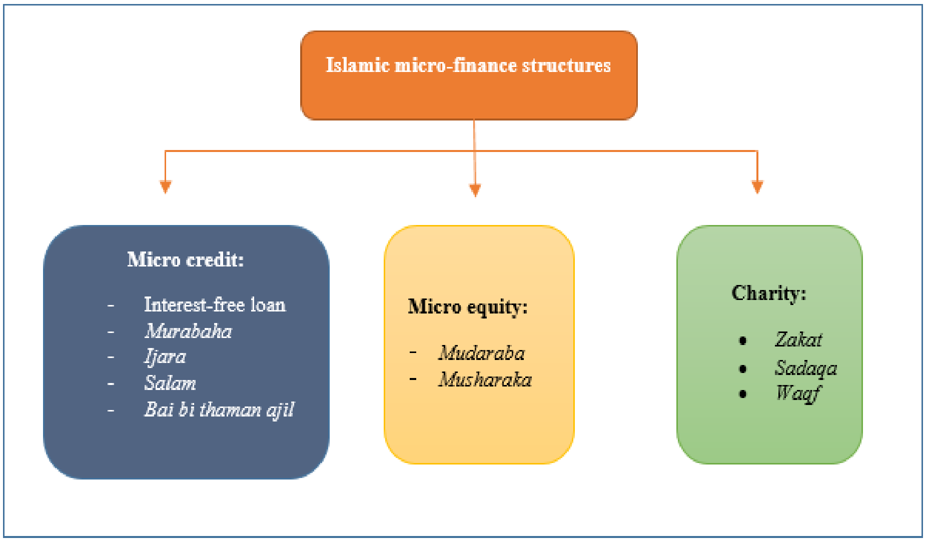

Figure 1: Islamic Micro-finance Structure
Source: GIFR (2012).

The major causes for default in the conventional micro-finance are diverting loan for consumption purposes and high interest rates; forcing the loan recipients' to sell their assets or further borrow in order to repay the initial loan. These factors retard the process of getting out of poverty (Laila, 2007).

Furthermore, there is evidence that suggest Islamic micro-finance has a comprehensive approach towards human empowerment, increased income and well-being. The products of Islamic micro-finance are designed on the assumption that human abilities are diverse in the face of opportunity. The micro-credit (*qardhul hasan)* provides an interest free source of funding, *murabaha* enables purchase of equipment that allows repayment in equal instalments, and *ijarah* is an operating lease providing rental payments. The concept of PLS is to ensure risk mitigation, and that optimal efficiency is achieved among the providers of factors of production (Rahman & Rahim, 2007). The PLS products in the form of *mudaraba* and *musharaka* arguably present more business opportunities for society. These partnership ventures share profit and loss (or harvest in the case of agricultural partnership) proportionately, and facilitate wealth redistribution as well as creating productive capacity that leads to industrial expertise. In order for Islamic micro-finance to develop and meet up with the aspirations of the Islamic economic system, it has to develop profit/loss sharing products (Saad *et al*., 2013). The charity aspect (comprising *Zakat, Awqaf* and *Sadaqah*) is to check inequality in wealth distribution and also ensure economic security and sustainability. The imperative here is to present the business with a sound basis as well as future prospects and the potential to develop into larger business ventures with well-trained entrepreneurs. This could also be seen from a business and developmental perspective. While the business perspective will provide opportunities for grass root entrepreneurial activities that is a prelude to small and medium size enterprises (SME) development, the society would be the beneficiary for empowering the less privileged (Riwajanti, 2013). According to Khan (2007), in Islamic countries, the philanthropic avenues in the form of *Zakat* and *Awqaf* are particularly essential to generate predictable and stable resources that could be channelled towards economic and human development. *Zakat* is one of the five pillars of Islam that is used as a distributive instrument to achieve economic as well as social goals (M. Akram & Afzal, 2014). *Awqaf* (plural of *Waqf*) is a perpetual charity that is created as a trust for the benefit of certain philanthropic purposes (Hassan & Ashraf, 2010). Both *Zakat* and *Awqaf* are instruments of wealth transfer that played a significant role in socio-economic development in the early Muslim societies. Studies on *Zakat* have maintained that, *Zaka*t is regaining its socio-economic relevance not only to alleviate poverty and correct inequalities, but also to achieve other goals of Islamic Economic system (M. Akram & Afzal, 2014). For Nurzaman (2011), the thrust of *Zakat* rests in targeting the poorest towards human welfare and equitable distribution of income. The *Zakat* recipients are identified based on their personal needs as specified in the Quran. The investment of *Awqaf* funds could generate higher return that is beneficial to the society in improving health, education and other resources. According to Saad *et al*., (2013), integrating *Waqf* with Islamic micro-finance could assist in reducing the cost of capital in operations of Islamic micro-finance and ensure utilisation of the combined resources. It will also avail the society a source of funding that is requisite for generating community assets, productive capacity building, wealth creation, and knowledge and skills that will enhance the technical standing of entrepreneurs. Hassan and Ashraf (2010) added that such integration may ensure equitable distribution of wealth and welfare of the poor, lower default rates, financial viability and sustainability of Islamic micro-finance in the long run. The objective of *Zakat* is to uplift the less privileged in the society and that could be achieved with managing the *Zakat* fund as a productive venture for the benefit of the society (Nurzaman, 2011).

3. Islamic Micro-finance and Human Development

Human development and welfare of human beings are important ends in Islamic economic development. According to ***MB Hendrie (2009),*** human resource development could be achieved "through expansion of useful production, improvement of the quality of life, balance development, development of technology suited to conditions of Muslim countries, and reduction of outside dependence and greater integration of Muslim world". The significance of human capital as a major ingredient in growth analysis has been espoused by both theoretical and empirical studies. Nussbaum and Sen (1993) for instance, have emphasised the importance of capabilities of human beings as an essential capital for development. This idea of capabilities has espoused the recognition given to human beings as the primary end and principal means of development, which was often neglected in the analysis of growth and development (Anand & Sen, 2000). The point is, human capabilities depend on factors such as education and talents, health, opportunities and other services, and hence the need to explore such factors (Stanton, 2007). Practical evidences have linked high levels of education as well as improved health services, increased productivity, towards improved satisfaction and a higher quality of life (Anand & Sen, 2000). Sen (2005) and Anand & Sen (2000) explains that human efforts, skills and talents are important in the promotion and sustaining of economic growth. Needless to say, the quality of human capital is significantly related to economic growth. Islamic micro-finance is based on these principles that seek to achieve prosperity for humanity. Several empirical studies have indicated the role played by Islamic micro-finance in creating opportunities for economic empowerment and human capital development, notably for the poor in the society. The role of Islamic micro-finance could be seen in the way it mobilizes factors of production, encourages risk sharing and ensures equitable distribution in income and wealth. This leads to achievement of Islamic socio-economic objectives, which include social justice, economic growth, efficiency and stability (Dusuki and Abozaid 2007; Saad *et al*., 2013).

Low literacy rate and lack of opportunities are among the reasons that made Muslim societies remain in poverty (M. Akram & Afzal, 2014; Shah, 2007). The level of education was found to contribute significantly to the economic performance of micro-credit recipients. The findings by Arabi & Abdalla (2013) on the impact of human capital on economic growth suggest that, quality of education has a determining role in the economic growth; health quality factor has a positive impact on growth as well. The study also confirmed that highly educated people are influencing more economic output when compared with secondary educated individuals. In a study to find the determinants of economic performance of micro-credit clients, Md Saad & Duasa (2010) confirmed that higher levels of education correlated to higher levels of per capita income. The Islamic micro-finance drive for financial inclusion is seen to bring improvements in human capital development, education and skills development, better provision of physical capital and wider access to micro-credit for the productive poor (Rahman *et al*., 2013). Furthermore, significant increase in clients' household income has been observed (Nawai and Bashir, 2009; Omar *et al*., 2012) and improved quality of life (Al Mamun, Adaikalam and Abdul Wahab, 2012). The findings in Chowdhury and Bhuiya (2004), while assessing the impact of Bangladesh Rural Advancement Committee (BRAC) programs in Bangladesh, have revealed a positive impact on human well-being, survival rate and schooling children, households' expenditure patterns and family planning practices. This provides supportive evidence that micro-credit contributes to reducing poverty, improvement in income, as well as non-income dimensions such as children education, health and nutrition, gender equality and women empowerment.

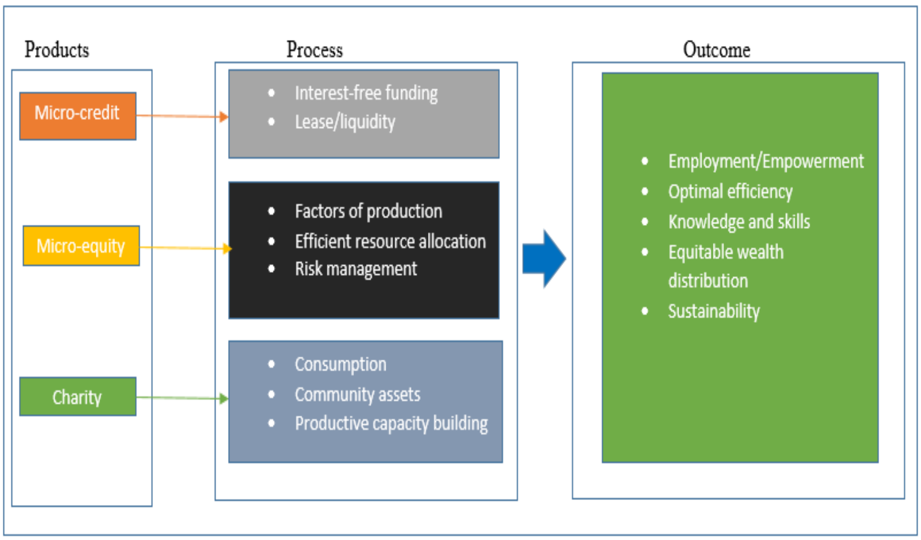

Figure 2: Islamic Micro-finance Conceptual Model

Increase in the income level of micro-credit recipients has been the yardstick of measuring successes of poverty reduction strategies but less at the wider goals of human well-being. The main goal of Islamic micro-finance is to achieve *falah* or well-being in this world that transcend to the next world and hence the need to see beyond income alone (M. Akram and Afzal 2014). This suggest concern for human wellbeing has a fundamental place in Islam, and more so, the inclusive idea to achieve that through Islamic micro-finance. An empirical study was carried out by Md Saad (2010) to evaluate the effectiveness of micro-credit as a tool for achieving human development. 1, 800 clients of Amanah Ikhtiar Malaysia (AIM) in Kelantan and Perak were involve. The study measured their socio-economic backgrounds, income, expenditure, health and education of their children. Analytical techniques such as descriptive statistics and correlation was employed in the course of the study. Findings were that micro-credit in Malaysia is able to uplift the poor from poverty by increasing the household income, spending and consumption.

Micro-equity comprises the *musharaka* and *mudaraba* products. In *musharaka*, parties contribute capital to run a business that gives them the right (to co-manage) not the obligation to manage the business. Profits and losses are shared in accordance with pre-negotiated rules (Mirakhor and Zaidi, 2007)). *Mudaraba* is a relationship between two parties, *rabbul-mal*, the supplier of capital and the *mudarib*, the entrepreneur that manages the business. While the *rabbul-mal* provides the finance, the *mudarib* uses his managerial skills and expertise to drive the business to profitability. Profits are shared in line with predetermined agreement while financial losses are borne by the investor (Gafoor, 2001; El-Gamal, 1997). This confirms the uniqueness of these factors of production in terms of capital and skills towards a productive enterprise and the extent to which both needs to be managed in order to ensure the desired result (Bidabad, and Allahyarifard, 2009). While credit worthiness of the customer is the main concern of the conventional banks, in contrast, the worth and profitability of the project is the major concern in PLS (Kahf, 2007). PLS is conceived to assure that optimal efficiency is achieved since profitability is the basic motive of the investment (Rachmawati and Syamsulhakim, 2004). According to Saad (2011), trading activities are found to be very lucrative and results in higher average income compared to production and service activities, yet the latter activities provides more opportunities to the society. The ownership structure in the productive sector facilitates a functional distribution of income among all the factors of production (Bidabad and Allahyarifard, 2010). It also employs a higher number of people, and that contributes to the economic development of the society. The risk sharing and equitable distribution of returns introduces a greater sense of discipline, requiring transparency by all stakeholders, and a more rigorous evaluation of financing that reduces volatility in the movement of funds. For sustainable economic growth capable of generating employment, opportunities will require the development of productivity and industrial expertise (Saad *et al*., 2013). According to researchers (Aziz Pahlavi and Gintzburger, 2009; Bidabad and Allahyarifard, 2009; Kahf, 2007), the PLS approach is unique and will have a greater impact on development due to the expected opportunities arising from the following:

- Venture capital market for long-term growth.
- Project financing of long-term risky ventures that ensure socio-economic development
- Economic empowerment, self-employment for micro entrepreneurs
- Risk management
- Linkage between real and financial sides of the economy.

However, Islamic micro-finance is still at infancy and lacks the capacity in capital and expertise to deal with agency problems in the form of conflict of interests, moral hazards and adverse selection problems (Mirakhor and Zaidi, 2007). The current practice in Islamic micro-finance is dominated by micro-credit as against the PLS that enhances venture capital market for long-term growth. According to Hasan (2002), practitioners may have found PLS inadequate either because they are not willing to take as much risk or the agency problems it presents. The PLS historically was used to finance less sophisticated short-term ventures, the business landscape of today that is characterized with large firms in the form of limited liability could present a greater challenge (Gafoor, 2001). In order to measure up to the aspirations of Islamic economics, Islamic micro-finance must pursue the course for micro-project financing of long-term risky ventures that ensure profitability and socioeconomic development (Saad *et al*., 2013).

The charity aspect is represented by *Zakat*, *Sadaqah* and *Awqaf*. In a study by Yumna and Clarke (n.d.) to investigate the impact of *Zakat*-based micro-finance, found that *qard al-Hassan* (interest-free loan) enhances the income and expenditure of micro-finance clients in Indonesia. The sample for the study consisted of 153 clients and 82 non-clients and employed ordinary least square to compare the welfare of the clients and non-clients groups. It was found that *Zakat* based micro-finance led to significantly higher annual income per capita for those in the non-client but impact on monthly expenditure is not evident. In another study by Nurzaman (2011), a comprehensive measure to find out the impact of productive-based *Zakat* in improving the welfare of *Zaka*t recipient by multiple regression simulations. The study population was defined as a group who have received finance from the 19 *Zakat* institutions in Jakarta, Indonesia for at least 6 months. Multiple regression simulations were performed to see whether *Zakat* has an effect to Human Development Index (HDI) and or to its components. It was found that the average HDI of *Zakat* recipients is lower than the average HDI both in Jakarta and at the national level. This implies that the impact of *Zakat* on the welfare of the recipients is not very high, or will take some time to feel its effect. It is also imperative to note that the minimum length of time, 6 months is, perhaps not adequate to realize a reasonable impact on the lives of the clients.

4. Summary and Conclusion

The definition of poverty as a deprivation in well-being signifies deprivation in food, education, health and other services. This is a wider approach that brings together the broader concept of human development. Islamic micro-finance has evolved to provide financial mediation for producing factors of production, goods and services through profit and loss, leasing and sale with emphasis on ethical and moral values in business. There is evidence to suggest that Islamic micro-finance has a comprehensive approach towards human empowerment, leading to human development in Muslim societies. The products of Islamic micro-finance are designed on the assumption that human abilities are diverse in the face of opportunity. The potentialities are noteworthy in the way it mobilizes factors of production, encourages risk sharing and the capacity for distributive equity in income and wealth. It seeks to achieve socio-economic objectives, which include social justice, economic growth, efficiency and stability. *Zakat* and *Awqaf* are requisite for generating community assets, productive capacity building, wealth creation, and knowledge and skills that will enhance the technical standing of entrepreneurs. This approach towards financial inclusion could bring improvements in human capital development, education and skills development, better provision of physical capital and wider access to micro-credit for the productive poor.

In conclusion, the concept of Islamic micro-finance is a growing market niche with significant potentialities. The developmental and ethical benefits to the society will enable it to compete favourably as an indispensable financial alternative. This work is a modest attempt to explore the role Islamic micro-finance toward achieving human development in a Muslim society. More work has to be done to improve the current study with empirical data.

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