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BAZNAS
Badan Amil Zakat Nasional

UNLOCKING

THE POTENTIAL OF ZAKAT AND OTHER
FORMS OF ISLAMIC FINANCE

to Achieve the SDGs in Indonesia



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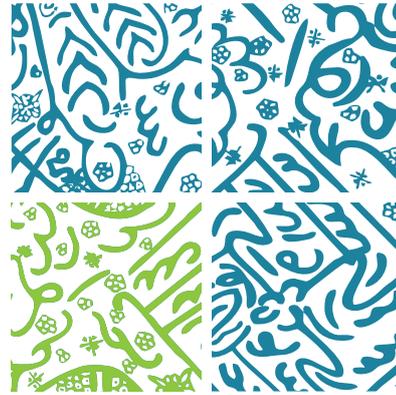
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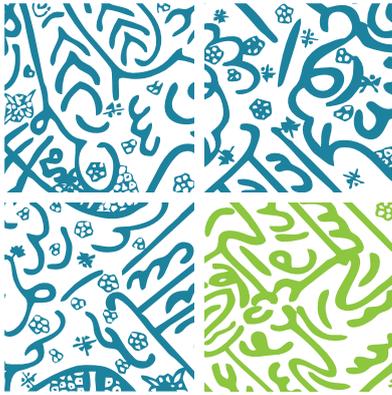
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TABLE OF CONTENTS



1	Abstract
2	1. Introduction
4	2. <i>Zakat</i> : A Powerful Force for Wealth Redistribution Witnessing a Paradigm Shift
8	3. Impact of <i>Zakat</i> on Development in Indonesia Thus Far
10	4. Remaining Challenges to <i>Zakat</i> as a Poverty Prevention Measure
11	5. Beyond <i>Zakat</i> : Islamic Microfinance, a Special Opportunity
13	6. Beyond <i>Zakat</i> : The Strong Potential of <i>Waqf</i>
14	7. Beyond <i>Zakat</i> : Investment in Infrastructure with <i>Sukuk</i>
15	8. How UNDP Can Contribute
17	References

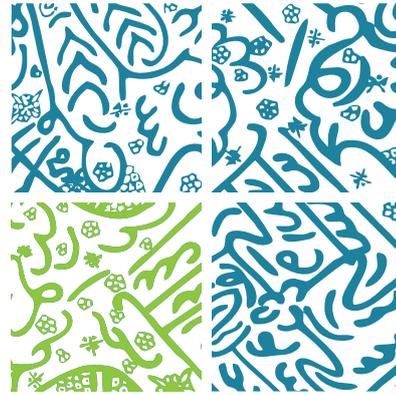


ABSTRACT

Indonesia's economy is growing and the country's citizens are well known for their generosity, especially for religious giving—including *zakat* and *waqf*. Indonesia has an unparalleled opportunity to alleviate poverty and achieve SDGs using the untapped potential of Islamic finance and funds, as funding from the Government and international development partners alone will not be enough. In this regard, *zakat* and the other forms of Islamic finance (*waqf*, microfinance, *sukuk*) offer an important key to achieving the SDGs. The quest for the United Nations Development Programme, Baznas and partners is to bridge that gap by unlocking the abundant resources of the country's private sector and religious giving.

Zakat, Islamic microfinance, *waqf* and *sukuk* are Islamic financing and funding instruments that can complement each other in eradicating poverty and promoting inclusive and sustainable economic growth. *Zakat* management in Indonesia has undergone major changes in approach and impact with promising results. *Zakat* can combine with other sources of Islamic finance to support entrepreneurship and expand financial inclusion. *Waqf* also is a charitable form of giving and is more flexible than *zakat*, which means it can be used for economic growth and income generation. While *zakat*, Islamic microfinance and *waqf* are largely charitable forms of funding, *sukuk* (Islamic bonds) are a commercial instrument that can attract financing to socially responsible development that also supports the SDGs.

1. INTRODUCTION



Indonesia has an unparalleled opportunity to alleviate poverty using the untapped potential of Islamic finance and funds. This follows the global adoption of Agenda 2030 and the Sustainable Development Goals (SDGs), for which a universal agenda to “leave no one behind” aims to end poverty, reduce inequalities, and fully incorporate not only social goals but also goals of environmental and economic sustainability. Yet between US\$3 trillion and \$4.5 trillion is needed annually to achieve the SDGs, while current investment in relevant sectors is around \$1.4 trillion, creating a financing shortfall of about \$2.5 trillion.¹

The implementation of the SDGs is well underway in Indonesia with a Presidential regulation (Peraturan Presiden Nomor 59 Tahun 2017²) on SDG implementation. Yet when it comes to financing, governments and international development partners alone cannot be responsible for the SDGs, leaving ample opportunity for increased and more effective philanthropic giving, social finance and private sector investment.

In this regard, *zakat*³ and other forms of Islamic finance (*waqf*, microfinance, *sukuk*) offer an important key to achieving the SDGs, by embodying socially responsible development, and

by bridging opportunities for economic growth and social welfare, particularly for the poorest and most vulnerable.

Striking commonalities exist between *zakat* and other forms of Islamic finance, and the SDGs, with their common focus on alleviating poverty and hunger and reducing inequality by redistributing wealth. *Zakat* and the SDGs overlap in terms of the five foundational goals of Islam⁴, namely, protection of:

- (1) faith, through reducing vulnerabilities, particularly to poverty, hunger, poor health, unsafe water and inequality (SDGs 1, 2, 3, 6, 10);
- (2) life, through eradicating food insecurity, ensuring healthy lives, tackling water scarcity, poor water quality and inadequate sanitation, ensuring decent work for all and making cities safe and sustainable (SDGs 2, 3, 6, 8, 11);
- (3) progeny, through promotion of peace and protecting the environment (SDGs 3, 5, 7, 11, 12, 13, 14, 15, 16);
- (4) intellect, by facilitating access to healthy nourishment and quality education to build human capital (SDGs 1, 2, 9); and
- (5) wealth, through generating economic activity and a social safety net (SDGs 1, 3, 8, 10).

Islamic finance also offers an underlying philosophy and rich partnerships that support the

¹ UNCTAD, 2014. *World Investment Report 2014 – Investing in the SDGs: An Action Plan*.

² Setkab.go.id, 2017.

³ UNDP and Baznas article in the Guardian: <https://www.theguardian.com/global-development-professionals-network/2017/jun/22/zakat-requires-muslims-to-donate-25-of-their-wealth-could-this-end-poverty>.

⁴ UNDP and Baznas Brief on *Zakat*: <http://www.id.undp.org/content/indonesia/en/home/library/sustainable-development-goals/the-role-of-zakat-in-supporting-the-sustainable-development-goal.html>.

SDGs. The Islamic finance industry is expanding rapidly, at a rate of about 10 to 12 percent annually.⁵ However, this extraordinary potential is largely untapped and overlooked, and has yet to be fully realized, even in Indonesia, as the world's largest Muslim-majority country⁶, in part because informal giving of *zakat* remains much larger than contributions made through formal Islamic organizations (e.g. Badan Amil Zakat Nasional (Baznas), the national *zakat* board; Dompet Dhuafa; Rumah Zakat; Pos Keadilan Peduli Umat).

Indonesia is exploring the connections between the SDGs and Islamic finance. An excellent start has been made: Baznas in mid-2017 extended its first contribution (US\$350,000) to support the SDGs in Indonesia, focused on renewable energy.⁷

The United Nations Development Programme (UNDP) in Indonesia, which promotes human-centred development to improve the quality of life for all, offers experience in strengthening institutions that are responsible for delivering services, as well as in reducing poverty through sustainable livelihoods programmes. It also offers access to first-class global resources, technology, knowledge and experience. UNDP is working with impact investing, crowd-funding and blended finance to support national and Islamic organizations to invest in development initiatives that benefit society, the economy and the environment alike, with an emphasis on communities and households in the greatest needs.⁸



Picture1.

Ground breaking ceremony of Micro Hydro Power Plant in Lubuk Bangkar Village, Jambi Province, the first SDGs project supported by *zakat*, CSR and Global Environment Facility on 6 April 2018. (Photo: UNDP)

⁵ Alawode, 2017.

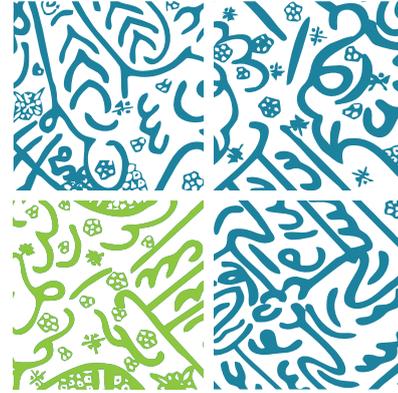
⁶ A voluntary *zakat* system through formal organizations is currently in place in Indonesia.

⁷ Indonesia's National Zakat Body Extends First Contribution to Support SDGs: <http://www.id.undp.org/content/indonesia/en/home/presscenter/pressreleases/2017/07/19/indonesia-s-national-zakat-body-extends-first-contribution-to-support-sdgs.html>.

⁸ UNDP Services for Financing SDGs in Indonesia: <http://www.id.undp.org/content/indonesia/en/home/library/sustainable-development-goals/undp-services-for-financing-sdgs-in-indonesia.html>.

2. Zakat:

A Powerful Force for Wealth Redistribution Witnessing a Paradigm Shift



Zakat—mandatory giving comprising at least 2.5 percent of income or wealth—should be paid by every eligible Muslim earning above a certain threshold, transforming *mustahik* (beneficiaries) into *muzakki* (givers). Put simply, *zakat* helps reduce poverty by redistributing wealth to all parts of society.

Globally, 22 percent of the population is Muslim, and Islamic finance, including *zakat*, reached an estimated value of around US\$2 trillion in 2015⁹, with assets of US\$3 trillion expected by 2020¹⁰. The worldwide value of *zakat* alone is potentially US\$200 billion to US\$1 trillion annually.¹¹

In Indonesia, *zakat* has shown a sharply increasing trend.¹² More broadly, there are different estimations on the potential of *zakat* in Indonesia. One study by the State Islamic University Syarif Hidayatullah, Jakarta, found the national potential of *zakat* ranged from US\$1.4 billion (Rp19.3 trillion) up to US\$16.2 billion (Rp217 trillion), or 3.4 percent of Gross Domestic Product (GDP).¹³ Similar with the finding by Islamic Development Bank (IDB), the potential of *zakat* in Indonesia alone is US\$16 billion (Rp217 trillion).¹⁴ Yet only 3 percent of this potential was realized in 2017, as reported by Baznas, and informal giving remains the norm.

Year	IDR (billion)	USD (million)	Growth (%)	GDP Growth (%)
2002	68.39	4.98	-	3.7
2003	85.28	6.21	24.70	4.1
2004	150.09	10.92	76.00	5.1
2005	295.52	21.51	96.90	5.7
2006	373.17	27.16	26.28	5.5
2007	740	53.86	98.30	6.3
2008	920	66.96	24.32	6.2
2009	1200	87.34	30.43	4.9
2010	1500	109.17	25.00	6.1
2011	1729	125.84	15.30	6.5
2012	2200	160.12	27.24	6.23
2013	2700	196.51	22.73	5.78
2014	3300	240.17	22.22	5.02
2015	3700	269.29	12.21	4.79
2016	5000	363.90	35.14	4.98

Table 1.
**Zakat, Infaq, Sadaqa (ZIS)
Collection in Indonesia
(2002-2016)**

Source: Baznas (2017)

⁹ IFSB, 2016. *Islamic Financial Service Industry Stability Report 2016*.

¹⁰ Martinez-Soliman, 2017.

¹¹ Obaidullah and Shirazi, 2015; World Bank and IDBG, 2016.

¹² A study by the Public Interest Research and Advocacy Centre (PIRAC), based on surveys in 10 major cities across the country, demonstrated that the average potential of *zakat* per individual giver rose some 60 percent between 2004 and 2007 alone, from US\$31 (Rp416,000) to US\$51 (Rp684,550).

¹³ The latter amount includes potential receipts from households, private companies and State-owned enterprises.

¹⁴ 'Overlooked' *Zakat* Could Unlock Billions in New SDG Funding: UNDP: <https://news.un.org/en/audio/2017/11/635862#.WmAVAqiWbct>.

Between 2002 and 2016 *zakat*, *infaq* and *sadaqa* (ZIS) accumulation¹⁵ grew by 38 percent annually, far outstripping GDP growth (Table 1) and indicating a heightened level of public awareness to pay *zakat* through *zakat* management organizations or agents. In 2005 and 2007, ZIS accumulation grew by 100 percent each year following the tsunami in Aceh and the Yogyakarta earthquake.

Zakat can potentially play an important role in preventing poverty. However, a paradigm shift was needed in the management of *zakat*, moving from a focus on the charitable act of giving to its impact in expanding the rights of the recipients. A shift was also needed from individual spending on consumption for basic needs, to broader focus on productive activities.

In 2011, a new law was passed (Undang-Undang Nomor 23 Tahun 2011) mandating Baznas as the one national institution responsible for collecting, distributing and coordinating the management of *zakat* through 34 Baznas offices in provinces and 514 Baznas offices in districts and cities as well as through private *zakat* institutions. Since that time, Baznas has promoted a programmatic and professionally managed approach¹⁶ that goes beyond the predominant *zakat* model of one-time, individual consumptive donations for short-term needs. Now, the emphasis is on more

sustainable approaches, such as student capacity building, training and the provision of initial capital for small and medium enterprises (SMEs). This principle of productive *zakat* seeks to empower the *mustahik* so that they can sustain sources of income in the long term.

Already, Baznas has benefited 6.8 million poor people, or 22.6 percent of Indonesia's poor population. Of these, the overwhelming majority of *mustahik* (89 percent) are considered poor and/or needy (*fakir/miskin*). This has been achieved by dividing the disbursement of *zakat* into five major areas: economy, education, *dakwah* (proselytizing), humanitarian support and health (Table 2). *Zakat* distribution programmes implemented by Baznas range from Disaster Emergency Response and Baznas Active Service, which offers one-stop service to *mustahik*, within an estimated time of seven days, to the Baznas Cost-Free Hospital in six locations and *Zakat* Community Development (ZCD).

Baznas programmes are adapted to the needs of the community and may be productive, consumptive or both. For example, the economic sector aims at productive programmes, whereas the health sector is fundamentally consumptive; education includes scholarships (consumptive, for tuition fees and daily needs) as well as student and staff coaching (productive).

Sector	Consumptive	Productive
Economy		√
Education	√	√
<i>Dakwah</i> (Proselytizing)	√	√
Humanitarian support	√	
Health	√	

Table 2.
Classification of *Zakat* Allocation

Source: Baznas (2017)

¹⁵ *Zakat* is the wealth or property of persons of a certain standard, which, when it has reached or exceeded a specified amount, is commanded by Allah to be given to persons such as the poor and needy. *Infaq* is voluntary spending or disbursement of wealth or property by persons of any means, simply to please Allah, without any expectation of reward or return. *Sadaqa* means a good deed and is not limited to giving away wealth or property, but rather, can encompass a smile or pleasant speech.

¹⁶ Indonesia Shows the World How *Zakat* and *Waqf* Can Support SDGs: <https://undpindonesia.exposure.co/indonesia-shows-the-world-how-zakat-and-waqf-can-support-sdgs>.

The proportions of *zakat* distributed to the five sectors have shifted from 2015 to 2016 (Table 3), moving to longer-term purposes of education and the economy, and with short-term humanitarian assistance decreasing. The benchmark is not simply the number of *zakat* beneficiaries who have received assistance, but

rather, the number of beneficiaries who have increased their standard of living after receiving *zakat*. In all, between 2015 and 2016 alone, productive *zakat* increased from 36 percent of Baznas distributions US\$55 million (Rp2.1 billion) to 50 percent US\$109 million (Rp2.7 billion).¹⁷

Table 3. Comparison of Zakat Allocations Based on Sector, 2015-2016

Sector	Allocation 2015		Allocation 2016		Growth (%)	Change
	Total Fund (US\$)	%	Total Fund (US\$)	%		
Economy	23,516,940	15.11	36,796,641	18.30	56	3.19 ▲
Education	32,243,880	20.72	62,908,955	31.28	95	10.56 ▲
Dakwah (Proselytizing)	22,653,582	14.56	31,227,910	15.53	38	0.97 ▲
Humanitarian Support	63,137,164	40.57	53,303,507	26.51	-16	14.09 ▼
Health	14,080,970	9.05	16,865,970	8.39	20	0.66 ▼
Total	155,632,164	100.00	201,103,134	100.00	29.22	

Source: Baznas (2017)

A good illustration of the potential of productive *zakat* is found in Langkat District, North Sumatra Province, where the giving of funds to fisherfolk has been accompanied by assistance to ensure the funds are used to buy boats or canoes for enhancing their work. Under this initiative, Baznas has prioritized five villages in the district's coastal area (Secanggang, Selotong, Pantai Gading, Jaring Halus, Kwala Besar) and is focused on improving fisherfolk's lives as a whole, particularly in the economic, education and health sectors.

Through Baznas' ZCD, *zakat* and Government funds are being used for a comprehensive community development programme that includes productive activities such as procurement of fishing boats and support to marine product SMEs as well as consumptive activities including support to health clinics, scholarships, early childhood education, house reno-

vation and assistive equipment for persons with disabilities. Altogether, 63 fisher families, or 285 persons, are expected to benefit from the programme, for which Baznas provided US\$22,014 (Rp295 million).



Picture 2.

Zakat funds are used to provide free healthcare services for *mustahik* (the poor and needy) at Rumah Sehat health centres across Indonesia. (Photo: Baznas)

¹⁷ Statistics of National *Zakat*, 2017.

In the same geographic area, *zakat* is being productively utilized through the establishment of Z-Mart and Z-Cafe to serve *mustahik*. Z-Mart—a minimarket with the concept of empowerment for the poor, both traders and buyers—is operated by 33 *mustahik*. Since its establishment in April 2017, the Z-Mart has increased its turnover, which now reaches US\$223-300 (Rp3-4 million) per day, with an average profit of 12.5 percent and dividends to *mustahik* of 10 percent. *Mustahik* benefited from Z-Mart in the form of US\$4 (Rp50,000) per person per day from sugar or rice wrapping activities, purchase of goods at a 30 percent cheaper price and from monthly wages of US\$56 (Rp750,000) per person for working in the shop.

The collaboration between Baznas, Bank Jambi and UNDP on renewable energy also is working

to eliminate poverty in Merangin and Sarolangun, Jambi Province. A poor area of the country, more than 1 in 7 of Merangin and Sarolangun's people do not have electricity, compared to about 1 in 12 nationally.¹⁸ With *zakat* and Bank Jambi's funding offered as part of corporate social responsibility (CSR), the partners are supporting establishment of four micro hydro power plants to raise the proportion of people benefiting from electrification and bolster rural livelihoods.¹⁹



Picture 3. Z-Mart program in Bojong Gede Village, West Java Province, receives *zakat* funds to support the business managed by *mustahik*. (Photo: Baznas)



Picture 4. Baznas provides *zakat* funds to a coffee peddler in Jakarta as part of its Economy programme. (Photo: Baznas)

¹⁸ According to data from the Ministry of Energy and Mineral Resources, 2017.

¹⁹ First in Indonesia: *Zakat* Financing Gives 'Rays of Hope' to Four Villages in Jambi:

http://www.id.undp.org/content/indonesia/en/home/presscenter/pressreleases/2018/4/first-in-indonesia--zakat-financing-gives-rays-of-hope-to-four-v.html?cq_ck=1523069998716.

3. Impact of Zakat on Development in Indonesia



Despite its middle-income status, Indonesia still faces daunting development challenges. In the Poverty Profile Report in Indonesia issued by the Central Bureau of Statistics (BPS, 2017), March 2017, the poor comprised around 27.7 million of the country's 261 million people, or 10.64 percent.²⁰ The maternal mortality rate remains high, at 305 women dying per 100,000 live births, and the prevalence of malnutrition and under-nutrition in children younger than age 5 years is 3.4 percent and 14.4 percent.²¹

Zakat can play a role in complementing Government assistance. For example, of the 28 million poor in 2014, 15,53 million received rice (*raskin*) or Community Temporary Direct Assistance (BLSM).²² Equally, the possibility of overlapping targeting between the Government and Baznas is being addressed through

data integration between the Ministry of Social Affairs and the Ministry of Home Affairs with the *zakat* body.

Impact of zakat is understood by zakat organisations both in terms of spiritual²³ and material needs. Evidence shows that zakat has a significant impact on poverty (Tables 4, 5). Average monthly income among *mustahik* in all 13 areas rose 27 percent following the programme, from US\$199 (Rp2,660,770) to US\$241 (Rp3,231,438). This was above the average rise recorded in all families' income.²⁴ In some districts (Sumedang), income soared by as much as 119 percent, from around US\$22 (Rp300,000) to US\$59 (Rp800,000). Further, average material value and average spiritual scores also rose, by some 12 percent and 9 percent respectively.²⁵

Table 4. Average Spiritual Score of *Mustahik* After Receiving Zakat

Average Spiritual Scale	
Before Programme	After Programme
3.84	4.21

Source: Baznas (2016b)

²⁰ Central Bureau of Statistics, 2017. *Poverty Profile Report*.

²¹ Ministry of Health, 2017. *Indonesia Health Report 2016*.

²² According to data from the National Team for the Acceleration of Poverty Reduction, 2014.

²³ According to the National Population and Family Planning Board, the indicator for prosperous family includes spiritual needs. However, the spiritual needs are not elaborated. Center for Islamic Business and Economic Studies developed a CIBEST Quadrant, which represents Islamic concept on poverty and prosperity, consisting four indices: welfare index, material poverty index, spiritual poverty index and absolute poverty index. The total value of those indices to be equal to 1.

²⁴ Baznas, 2016b.

²⁵ Beik and Arsyianti, 2016.

Table 5. **Average Income of Mustahik**

No.	Monthly Income	Before Programme (Rp)	After Programme (Rp)	Impact (%)
1	Bandung Barat	1,678,791	2,059,585	22.68
2	Bantul	1,998,558	2,550,077	27.60
3	Tabanan	3,894,061	4,626,192	18.80
4	Sumedang	371,605	814,553	119.20
5	Sukabumi	3,516,859	4,237,977	20.50
6	Gresik	1,754,850	2,103,600	19.87
7	Semarang	2,188,077	2,882,885	31.75
8	Aceh	7,494,553	8,043,250	7.32
9	Nusa Tenggara Barat	4,464,753	4,964,753	11.00
10	Kutai Timur	2,471,800	3,948,828	60.00
11	Gorontalo	1,614,286	1,731,429	7.00
12	Sijunjung	1,590,333	2,014,917	27.00
13	Siak	1,551,482	2,030,648	31.00
Average		2,660,770	3,231,438	27.00

Source: Baznas (2016a)

Although no studies yet have examined the knock-on impact of the increased income on improving access to basic needs such as health care and education, such impact seems likely.

The impacts of *zakat* are also seen in the growth in *muzakki*, although the numbers of *mustahik* have expanded as well (Tables 6 and 7).²⁶

Table 6. **Total Muzakki in Indonesia**

Year	2012	2013	2014	2015	2016
Individual	700	33,492	28,033	56,837	119,332
Institutional	520	3,396	2,143	3,066	7,568
Total	1,220	36,888	30,176	59,903	126,900

Source: Baznas (2017)

Table 7. **Total Mustahik in Indonesia**

Year	2012	2013	2014	2015	2016
Individual	428	20,557	9,487	42,270	104,145
Institutional	25	2,218	3,291	3,332	5,772
Total	453	22,775	12,778	45,602	109,917

Source: Baznas (2017)

²⁶ Institutional *muzakki* are non-individual *zakat* payers, such as companies. Institutional *mustahik* are non-individual beneficiaries, such as communities.

4. Remaining Challenge to *Zakat* for Poverty Prevention



Despite *zakat*'s tremendous potential, numerous challenges remain. These include low awareness of the need to pay *zakat* despite its mandatory nature as a pillar of Islam and a wariness with regard to channelling funds through formal *zakat* institutions. This is exacerbated by the preference of most *muzakki* toward short-term, interpersonal offerings as well as by a low tax incentive for *muzakki* in Indonesia to pay *zakat*; *muzakki* are offered a tax deduction, which is subject to double payment, rather than a tax credit.²⁷

Zakat should not be perceived as a corrective measure to reduce poverty, but rather, as a positive measure to redistribute wealth in order to prevent poverty (preventive/anticipatory).²⁸ When there are more poor people, the amount of *zakat* collected will not be sufficient. Thus, there exists no built-in, counter-cyclical increase in formal expenditures, which is the weakness of *zakat* alone as a poverty prevention measure.

Expanding access to the unbanked segment of the population is also a challenge. Nearly two in three Indonesian adults (64 percent) do not have a bank account²⁹, and have relatively low financial literacy and inclusion compared to other countries in the region. In 2016, the national financial literacy index stood at 30 percent—lower than both Malaysia and

Singapore, at 65 and 98 percent respectively—and the financial inclusion index at 68 percent.³⁰ In addition, *sharia* financial literacy and inclusion were at 8 percent and 11 percent respectively.³¹

The introduction of *zakat* into the next generation of financial inclusion programmes offers the breakthrough required, providing a branchless banking system that will improve the process of collection and distribution of *zakat*. This can be complemented by technological advances through online banking and mobile money, which can make it easier for people to make *zakat* contributions, particularly through formal channels.

Improving efficiency and effectiveness in the performance of *zakat* institutions is also important. People must be convinced that giving through a formal organization is better than through informal networks. Moreover, the collection of *zakat* continues to focus only on *zakat fitra* (payment at the end of fasting during Ramadan) overlooking other types of *zakat*, such as *zakat maal* (an obligation applicable to all financial belongings, including from trade, agriculture, livestock, gold, silver and income). Greater trust, transparent and effective governance, and demonstrating impact are critical for *zakat* and to get closer to achieving its full potential.

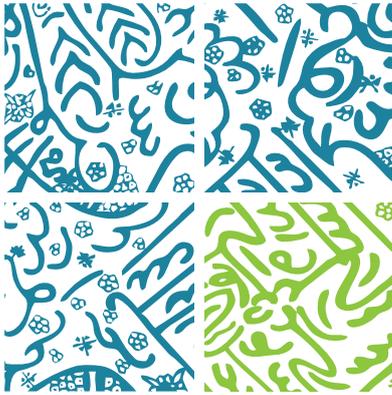
²⁷ However, a tax deduction cannot be obtained without a valid letter from Baznas demonstrating the *zakat* payment, as required by the Directorate of Taxation.

²⁸ Buana, 2017.

²⁹ Indonesia Financial Services Authority (OJK), 2016. *National Survey of Literacy and Financial Inclusion* (SNLIK).

³⁰ *Ibid.*

³¹ *Ibid.*



5. Beyond Zakat: Islamic Microfinance, a Special Opportunity

After receiving *zakat* as an initial lift, people may also need other forms of finance and capacity building to stay out of poverty, moving beyond survival to grow their livelihoods and businesses. *Zakat* can combine with other sources of Islamic finance to support entrepreneurship and expand financial inclusion.

Financial inclusion can be achieved through the following *sharia* compliant approaches: (1) redistribution of wealth, such as *zakat*, *sadaqa*, *waqf* and *qard hasan*, and (2) risk-sharing as a substitute for debt-based financing, through microfinance, small and medium enterprise financing and microinsurance.³²

Microfinance can support the poor³³ by contributing to productive activities, increasing revenues and savings, and allowing households to generate capital. However, microfinance generally charges interest rates higher than banks. For a Muslim community that prohibits paying interest, it is difficult to access microfinance.³⁴

Islamic microfinance offers interest-free contracts. There are three sources of finance: 1) Donations based on *tabarru* (a voluntary charitable action) can include *zakat*, *infaq*, *sadaqa*, *waqf* (an endowment made by a Muslim to a religious or charitable cause) and *hibah* (gift or donation); 2) Deposits including *wadiah* (safe-

keeping/custody/trust), *qard hasan* (benevolent loan) and *mudarabah* (a partnership where one party provides capital/funding, while the other party provides expertise/personal effort); and 3) Equity including *musharakah* (a partnership where each party contributes to the capital).

Among the several types of Islamic microfinance, some of the most popular include Islamic cooperatives and *Baitul Maal wat Tamwil* (BMT). The difference between the two is that BMT can encompass *zakat* institutions while Islamic cooperatives cannot collect *zakat*. BMT can play a financial role and also engage in capacity building. BMT consists of two bodies: *Baitul Maal* and *Baitut Tamwil*. It is owned by the community, collecting members' deposits and redeeming them to the members through financing or credit products. The *Baitul Maal* seeks to collect funds from members of the community in the form of *zakat*, *infaq* and *sadaqa*, and to redistribute the funds to those entitled to receive them, or to loan to members who particularly need them due to financial distress, through *qard hassan* financing products (benevolent loan or zero-percent interest). At the same time, the *Baitut Tamwil* seeks to collect public funds in the form of principal savings, mandatory savings, voluntary and time deposits and grants.

³² Mohieldin *et al.*, 2011.

³³ United Nations, 2005.

³⁴ El-Komi and Croson, 2013.

In several countries as well as Indonesia (Bosnia and Herzegovina, Islamic Republic of Iran, Pakistan, United Kingdom), *qard hassan* is being used to extend microfinance. In Aceh Province, Baznas acts as *Baitul Maal*, offering *qard hassan* as well as productive *zakat*.

A successful example is BMT Beringharjo in Yogyakarta Province. A *sharia* financial service was established in 2004 and by 2011 had accumulated assets of US\$4.6 million (Rp62 billion), serving 30,000 people and with 110 employees.³⁵ Analysis³⁶ showed that turnover received by BMT members after financing by BMT Beringharjo (ZIS, investment) had increased, and SMEs that obtained financing expanded, with growing numbers of customers and workers.

In addition to BMT, Bank Rakyat Indonesia (BRI) also provides Islamic microfinance. BRI formed 'village units' to expand access and target the poor in suburban areas and has achieved high repayment performance.³⁷

Nonetheless, challenges again remain: Overall, Islamic microfinance requires both strengthened accounting standards and more qualified staff, while further efforts are needed to attract clients. A lack of institutional investor participation, as well as high administrative fees have kept *qard hassan* from gaining wider popularity in financial lending.

In addition to BMT, there are some good practices, which comply with *sharia*, that have been implemented in Indonesia. Amarta.com in

Jakarta is a fintech-based peer to peer, or person to person (P2P) lending for microfinance. Amarta.com has been the pioneer of P2P lending for the unbanked community. It can reach people who live in the countryside and connect micro-entrepreneurs in remote areas with individual investors who are interested in both making profit and providing social impact.

Kredit Mesjid Sejahtera (Mesra) by BPR Kota Bandung was officially launched in August 2017. It channels credit through Islamic cooperatives, which are located in mosques around Bandung. The initiative came from the idea of mosque as the centre of economic growth.

Pembiayaan Usaha Syariah (Pusyar) Islamic Rural Bank (BPRS) Kota Mojokerto is a third example. It is a collaborative project between PT BPRS Kota Mojokerto with Badan Amil *Zakat* Kota Mojokerto. It has provided capital financing using *qard hassan* (benevolent loan) contracts to Micro, Small, and Medium Enterprises (MSMEs) since 2012.

UNDP also has worked on Islamic microfinance in Palestine to support entrepreneurs to establish their own SMEs by providing technical assistance, business development, training, awareness and capacity building, and monitoring activities. UNDP Palestine, the Islamic Development Bank Group, and the Organization of Islamic Cooperation collaborate on this project that combines *waqf* with microfinance to support enterprise development.

³⁵ Umam, 2013.

³⁶ Nurromah, 2015.

³⁷ Maysita, 2012.



6. Beyond Zakat: The Strong Potential of *Waqf*

While the potential role for *zakat* is increasingly being harnessed for sustainable development, the role of *waqf* is less so. The guidelines on utilizing *waqf* are explained in the Qur'an Surah Ali-Imran: 92, "You will not attain virtuous conduct until you give of what you cherish. Whatever you give away, God is aware of it."

Waqf is also a charitable form of giving and is more flexible than *zakat* while also being longer-term, and can be used for economic growth and income generation. Generally, *waqf* involves donating a plot of land, building or other assets for religious or charitable purposes, with no intention of reclaiming these assets. This land can be used to develop the local economy, such as through farming. *Waqf* has huge untapped productive potential in Indonesia, comprising land five times the size of Singapore (4,300 sq.km.), in 435,768 locations, and with a value of US\$27 billion (Rp370trillion).³⁸

At the same time, cash *waqf* is also growing. A key outcome from a recent panel discussion at a UNDP innovative financing event was that there is scope to consider using *waqf* as a social impact financing tool. Already, Badan Wakaf Indonesia (BWI), the Indonesian Waqf Board, has cooperated with various parties in managing *waqf* land productively. Among these are

uses for plantations, livestock, hospitals and mining.

A good example of *waqf* land being used productively is Rumah Sehat Terpadu hospital. The hospital pioneered free healthcare for the less fortunate when it was established in 2012. Managed by Dompot Dhuafa, a humanitarian NGO, the hospital provides free healthcare for the needy and less fortunate, and has capacity to support 10,000 patients monthly. The hospital is built on *waqf* land and its operational costs are covered from *zakat*, *infaq*, *sadaqa* and *waqf* endowments. Opposite the hospital is Smart Ekselensia Indonesia, a secondary boarding school for less fortunate children from all over Indonesia, also funded through religious contributions. Similarly, Ahmad Wardi eye hospital in Serang, Banten, the westernmost province of Java, established by BWI and Dompot Dhuafa provides free of charge services to the poor.

UNDP Indonesia is working³⁹ with BWI to develop a *waqf* digital platform to encourage *waqf* contribution for SDGs, raise awareness on the importance of giving *waqf* and promote trust in *waqf* management institutions. Since the Indonesian demographic composition is dominated by tech-savvy youth, *waqf* crowdfunding is expected to be a significant breakthrough, leveraging and scaling up cash *waqf*.

³⁸ Badan Wakaf Indonesia, 2016.

³⁹ *Waqf* for Financing the Sustainable Development Goals (SDGs): <http://www.id.undp.org/content/indonesia/en/home/presscenter/articles/2017/12/11/untapped-great-potential-of-waqf-for-sustainable-development-in-indonesia-.html>.

7. Beyond Zakat: Investment in Infrastructure with *Sukuk*



While *zakat*, Islamic microfinance and *waqf* are largely charitable forms of funding, *sukuk* (Islamic bonds) are a commercial instrument to attract financing. Unlike conventional bonds which are a debt obligation, the presence of underlying assets in *sukuk* is compulsory for it to be compliant with *sharia*. As *sukuk* grant partial ownership in the underlying assets, investors have the right to receive profits, meaning that selling *sukuk* is selling ownership of the assets. The value of assets determines the *sukuk* price, while conventional bonds pricing is based on a credit rating and the profits correspond to the fixed interest (*riba*) which is prohibited in Islam. *Sukuk* can capture both *sharia* and conventional consumers.

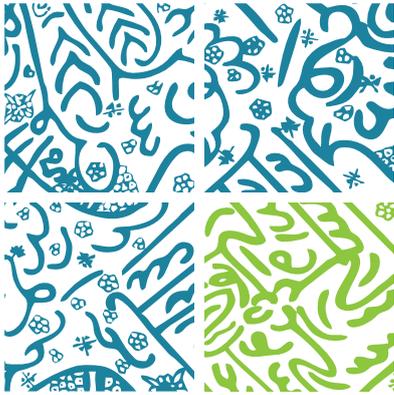
The issuance of *sukuk* is usually intended for general funding purposes or for financing infrastructure projects, such as dam construction, power plants, ports, airports, hospitals and toll roads. Indonesia is one of the few countries that regularly issues *sukuk* in the domestic market through a scheduled auction. *Sukuk* can leverage private finance for investment in infrastructure in areas where SME develop-

ment is taking place thereby providing a local economic environment where SMEs are more likely to thrive.

The Government has issued retail *sukuk* at affordable prices to encourage financial inclusion. Central Bank of Indonesia, BWI, and Ministry of Finance are planning a *waqf*-based *sukuk*. It could be implemented under the scheme in which *waqf* lands are used for underlying *sukuk* issuance. In addition, the return of the *sukuk* could also be utilised for financing MSMEs through Islamic microfinance.

UNDP Indonesia supported the Ministry of Finance prepare to issue its first sovereign Green *Sukuk* in February 2018. This is the first sovereign green *sukuk* issued in dollars anywhere in the world. It followed a UNDP project to support the Ministry of Finance's performance-based budgeting to integrate climate change mitigation and adaption within the Government's planning and budgeting processes.⁴⁰ This project helped identify the projects within the Government budget that could become part of the *sukuk*.

⁴⁰ Indonesia Tackles Climate Change Through the Issuance of Green *Sukuk* (Islamic Bond): http://www.id.undp.org/content/indonesia/en/home/presscenter/pressreleases/2018/4/indonesia-tackles-climate-change-through-the-issuance-of-green-s.html?cq_ck=1522745732024.



8. How UNDP Can Contribute

Different forms of Islamic giving and commercial financing, while separate and with different rules governing their use, can complement each other when viewed holistically. After receiving an initial lift from *zakat*, other forms of finance, such as Islamic microfinance, can help people move beyond survival to grow their livelihoods and businesses. Cash *waqf* can be used to invest in

micro and small economic activities through revolving funds for micro-enterprises as long as the initial value of the assets is retained. Moreover, financing instruments, such as *sukuk* can encourage investment to promote inclusive, sustainable economic growth. In this way, different Islamic funding and financing instruments can play an important role in poverty elimination and achievement of the SDGs.



Figure 1. *The Complementarity Scheme of Islamic Finance Instruments*

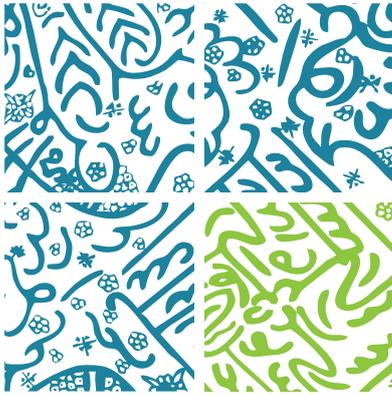
As part of the move from funding toward financing for development, UNDP Indonesia has acquired much rich, in-depth knowledge and experience on different forms of innovative financing. Its new Innovative Financing Lab, conceptualised with Baznas and other partners in 2017, focuses on how to unlock and leverage new finance, including Islamic finance, to close the SDG funding gap. The Lab will design and test new financing instruments and help enhance investments for higher SDG returns, measure progress as well as evaluate impact. It also seeks to convene through a platform the different forms of Islamic finance and funds to support the achievement of the SDGs.

Overall, UNDP Indonesia can help *zakat* and other religious funding and financing organizations address poverty, inequality, and other areas of common interest that are outlined in the *Maqasid al Shariah* and SDGs. UNDP can assist with identifying the communities and households in greatest need, identifying key vulnerabilities, and how to overcome them in a sustainable manner. As *waqf* and *zakat* organizations seek to move to more productive approaches to poverty alleviation, UNDP can help identifying sustainable and inclusive interventions that promote entrepreneurship and local economic development.

UNDP Indonesia seeks to extend its partnerships with Islamic finance organisations to design more impactful projects for which *zakat*, *waqf* and other religious funds and financing could be deployed. Further, the *zakat* funding can be used to attract additional financing, both from philanthropy and investment financing.

There is also scope to support religious organizations improve the governance and manage-

ment of funds, which in turn improves trust and generates increased contributions through these formal channels. Technology, including digital and online technologies, can for example, play an important role in improving outreach as well as the collection and distribution of funds.



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