Making Economics More Human and Alleviating Poverty with Islamic Finance

by Namira Samir

Economics taught us how to win, not how to be equally equipped. From Adam Smith's rational economic man, John Nash's Game theory, Stolper-Samuelson theorem, they are all about winning. If everybody wants to win, then how do the economics itself achieve its famously defined objective; to allocate scarce resources efficiently?

Robert Frank, a Professor of Economics at Cornell University said that the discipline of economics tends to attract self-interested people. It is a valid opinion considering the absence of equality or socio-economic justice in most economic theories, even though it is extremely upsetting considering inequality and poverty are two of the major concern in economics.

We are trapped in utilizing theories which were made centuries ago, values them highly and are afraid to criticize and revise them despite our inner instinct that these economic theories only make our lives worse, self-centered and not purposeful.

In the Indonesian banking universe, 51.1% of the population remains untouched by the financial industry, included those who are unable to obtain credit because they don't have the collateral, a 2018 data by Financial Inclusion Index revealed. Financial technology is working to help the unbankable population, though they will still not able to make banks kinder and more human. That's just not the purpose they intend to achieve. In a way, banks are like architects; they can create something out of nothing. If architect creates a new building, banks create new money by issuing a loan with interest rates.

Never ask why bank is like that, because the answer is crystal clear. It is because they have been using the wrong compass all along. Interest rates is considered as the only powerful way to control money-supply (they are forgetting the role of open market operation) and generate growth (they are forgetting that banks finance business, and business is all about collaboration between mankind to benefit each other).

Socrates's sayings "an unexamined life is not worth living" is a single overarching belief that must be applied in situations where humans are becoming less and less mindful. What if, instead of maximizing profit, banks change its purpose to ensuring that profit and loss are managed and shared equally among parties; be it the bank, the shareholders, and the customers. This will change the whole dynamic of financing, from self-centered to society-centered.

Another unexamined thing in economics is poverty alleviation strategies. Positioned as a lower middle-income country (LMIC), Indonesia is experiencing a number of issues that hinder the country's growth and development. Case in point poverty rate in Indonesia (yes, the number is declining but not at a fast-pace). As the complexity of poverty increases, we must try to look out for better strategies. Yet, social assistance and interest-based credit for the poor still become this country's biggest champions. We have witnessed the harsh reality that the current strategies will never be able to achieve the pre-determined goal of poverty rate at 7% by 2019 in Indonesia's National Medium-Term Development Plan (RPJMN).

Sadly, realization of this phenomenon does not come from those who have the capability to make a reform.

It was Alex Murphy who elaborated how sometimes situation do not conform to general assumptions. Central Government assumes that the current financial mechanism or programmes will work effectively. But they forgot to take “socio-economic justice” into the equation. Poverty might be reduced, financial inclusion might demonstrate an increase, but at the same time inequality in and between regions are at rise.

Economic theories that are proven to only contribute to rising inequality must be reformed and changed to the one that potrays the shared resources between humankind as the main purpose of economic activity. Kate Raworth in her book “Doughnut Economics” said that the portrait we paint of ourselves clearly shape who we become, which is why we must begin (if haven’t yet) to look out for a reliable compass, a dependable economic theory or approach in order for the society’s well-being to improve.

The incorporation of Sustainable Development Goals (SDGs) into Indonesia’s development agenda has at least made growth more humanistic. But what’s the point of all that if we still rely on same old theories and instruments?

In Indonesia, we can at least see the growing use of Islamic Finance as an alternative financial instrument aimed at ending human deprivation. Islamic finance arrived from ontological source that wealth must be distributed equally and that any kind of activities that will only lead to expropriation of others’ wealth or cause humans to deviate from justice values in the economy are strictly forbidden.

Islamic Finance is an economic approach seeks to promote a sharing economy whereby benefits are sharing equally and not only in the hands of a few individuals (or banks). It is what we have been looking for to achieve the global goals and ensure that no one falls outside the doughnut’s safety zone, as Kate Raworth suggested. Financing is provided on the principle of profit and loss sharing, hence interest rates are prohibited. The 2007-08 Financial Crisis has showed us the imperfection of interest rate and how it led to the financial meltdown which affects the World Economy heavily.

Aside from the Commercial Finance, Islamic Finance also offers instruments that targets socio-economic issues such as poverty and inequality, namely zakat, waqf and Islamic Microfinance

Zakat is an important pillar in Islam, a form of almsgiving aiming to solve wealth redistribution issue that contributes to both poverty and rising inequality in almost every place that we’ve been to. In Zakat, the eligible recipients are those who are included in at least one of the eight kinds of people including the poor, the needy, the slaves, the people who are in debt, etc. Hence, zakat does not only target the poorest category, but also those who are vulnerable to fall below the poverty line. There are two forms of zakat: zakat fitrah in which the poor are supported with basic needs, and zakat mal, in which a 2.5% percentage of money of the wealthy are distributed to the poor. There have also been many examples where zakat fund is utilized for empowerment programme, which eventually improves its significance on alleviating poverty in all its forms.

Meanwhile, Waqf which is an Islamic Endowment aims to resolve asset redistribution issue by enabling endowment of land or cash of people who are willing to contribute to tackle socio-economic issues, be it education, poverty or homelessness. There is also Islamic Microfinance with its empowerment and socially-driven objective that aims to lift the poor out of the poverty trap by providing interest-free loan without the need to provide physical collateral.

Alas, despite of its potential significance to achieve a balanced economic activity and growth, Islamic finance asset in Indonesia only accounts 8.58% of Indonesia's financial asset (OJK, 2018). The number does not seem to make sense considering 85% of Indonesia's residents are Muslims. Many still prefer the several century-long financial industry, because it offers guarantee in terms of benefits and some do not yet understand the fundamental reasons of Islamic finance establishment.

Reasons that are often put forward on why customers prefer Conventional Banks over Islamic Banks are the complexity of shari'ah contracts (contracts based on Islamic principles), higher Profit-Loss Sharing Margin than Interest Rate Margin of Conventional Banks, and failure to fully comply with Islamic principles.

Nevertheless, we must be reminded that in comparison to the Conventional Banks, Islamic Banks is still on its embryonic stage. Its conceptual idea of how the banking and financial system should not depart from a "profit-oriented mind" is certainly an implementable one. However, it necessitates improvements in various aspects and on both sides of the business, On the banking side, what is required is the development of human resources so as to enhance their competence in shari'ah, economics and business practices. Meanwhile, it must also work on how to improve potential customers' awareness and understanding of the Islamic banks itself since this is believed to play a dominant role on the lack of Capital hold by Islamic Banks, which eventually contribute to a higher PLS Credit Margin.

In addition, to showcase and demonstrate its commitment on serving the society and contribute to a balanced economic growth, more engagement between the commercial and social side of Islamic finance is necessary so that the overarching purpose of Islamic finance to reduce inequality and achieve socio-economic justice could be realized.

Islamic Finance surely requires a good deal more improvement but the first step we must do is to belief in this new way of doing economics that can transform the current economic system to be more just and not egocentric.

Recommended books:

1. Islam and the Moral Economy: the Challenge of Capitalism by Charles R. H. Tripp
2. Islamic Finance: Principles and Practice by Edward Elgar Publishing
3. Islamic Social Finance: Entrepreneurship, Cooperation and the Sharing Economy (Islamic Business and Finance Series) by Routledge Publishing.