THE EFFECT OF ISLAMIC MICROFINANCE ON POVERTY ALLEVIATION: STUDY IN INDONESIA

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ABSTRACT

This study was conducted to examine the role of Islamic microfinance on poverty alleviation. The four indicators of poverty alleviation were used: income levels, children's education, health care, and business progress. This study used the sample of 150 borrowers from 20 Islamic microfinance institutions in Central Java, Indonesia. The questionnaires were distributed to them using the purposive sampling method. Out of 150 questionnaires distributed, the researchers received back 124 responses. The empirical tests indicated that microfinance has a significant role on improving income level, children's education, and business progress. However, the study did not find any significant role of microfinance in access to health care. Implications, limitations and suggestions for future research are discussed.

Keywords: Islamic microfinance, Poverty alleviation, Indonesia.

JEL: G21, I32

1. INTRODUCTION

Poverty has been a major development problem of Indonesia. According to the Indonesian Statistics Bureau (2012), around 29 million people live in poor conditions. Poor people do not only have low income but also lack access to the basic needs such as education, health care, clean drinking water and proper sanitation. The most important constraint that poor people face to come out of poverty is the lack of access to credit to run their own businesses due to several reasons. First, formal financial institutions require collateral. Second, they prefer high-income clients with large loans. Third, the bureaucratic processes and procedures in providing loans are complex. Finally, the loan for the poor is not attractive and profitable (Gebru and Paul, 2011). So, microfinance became a solution for these problems.

Microfinance has been gaining popularity for the last few decades, especially after the experience of the Grameen Bank in Bangladesh. The microfinance industry stands at a crossroads between increased commercialization and increased philanthropic aid (Emily, 2005 in Shirazi and Khan, 2009). Microfinance refers to small-scale financial services, primarily credit and savings provided to small enterprises or micro enterprises. However, the field of microfinance has broaden greatly beyond credit only, to include micro-savings, micro insurance, remittances and other payments, all of which have a great impact on the lives of the poor.

Several studies indicate that microfinance has positive impacts in reducing poverty (e.g. Gebru and Paul, 2011; Shirazi and Khan, 2009; Kessy and Urion, 2006; Durrani, Usman, Malik, and Ahmad, 2011). Moreover, conventional microfinance products have been successful in Muslim majority countries such as Indonesia, Bangladesh, Pakistan, Turkey and etc. However, these products do not fulfill the needs of all Muslim clients, so the Islamic

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microfinance is solution. Islamic microfinance is combining the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor especially for those who think that interest is prohibition in Islam (Dusuki, 2008). The prohibition of interest in Islam provides the microfinance industry with an opportunity to offer financial services to the poor mainly through a new emphasis on profit-generating activities in Islamic microfinance (Shirazi and Khan, 2009).

Despite the call for Islamic microfinance, there has been very little academic research on the topic. There have been even fewer attempts to investigate the implementation of Islamic microfinance to poverty especially in Indonesia. Therefore, the goal of this study is to examine the role of Islamic microfinance in poverty reduction in Indonesia.

2. LITERATURE REVIEW

2.1. Islamic Microfinance in Indonesia

Indonesia's first formal microfinance began in the late 19 century with the establishment of the People's Credit Bank and Lumbung Desa by the Government. These institutions were formed in order to assist farmers and workers to free themselves from loan sharks. In 1905, the People's Credit Bank was upgraded to become the Village Bank whose services were expanded to all business activities for the small enterprise (Usman, et al., 2004).

In 1997, Indonesia's economy was devastated by the Asian financial crisis. Inflation reached 80 percent and unemployment increased to as high as 20 million. The number of people living under the poverty line is estimated to have risen to 80 million, or about 40 percent of the population (Suryahadi, Hadiwidjaja, and Sumarto, 2012). After the crisis, Indonesian economy grew rapidly. During 1999-2012, Indonesia's economy grew on average more than 5%. The poverty declined from 80 million to 29 million. Moreover, the development of the Indonesian economy was directed to accelerate the economic recovery and to strengthen the sustainable economic development, which is based on micro, small and medium enterprises (MSMEs) (Widiyanto, 2007).

Furthermore, to support the huge number of MSMEs, the banks need to provide the capital or credit to fund the development and success of MSMEs. Nevertheless, MSMEs have difficulties in obtaining credit facilities from the banking system, because most of them cannot fulfill the 5C requirements of the banks (Character, Capital, Collateral, Capacity, and Condition) (Ismawan and Budiantoro, 2005). In order to solve the capital need, several community groups have been currently supported by the government-established Microfinance Institutions (MFIs). This has given great benefits to the micro-enterprises considered as special institutions that provide credit facilities for the micro-enterprises (Widiyanto, 2007; Sebel and Agung, 2008).

There are several types of MFIs in Indonesia, namely, BRI Unit Desa, Rural Bank (*Bank Perkreditan Rakyat* / BPR), Pawnshops, *Danamon Simpan Pinjam* (DSP) Bank Bukopin and *Swamitra* Units, Village Credit Boards (*Badan Kredit Desa* / BKD), Rural Credit and Fund Institution (*Lembaga Dana Kredit Pedesaan* / LDKP), Cooperative, Village Saving and Credit Units (*Unit Ekonomi Desa-Simpan Pinjam* / UEDSP), Savings and Credit Service Posts (*Tempat Pelayanan Simpan Pinjam* / TPSP). All of them operate on the basis of the conventional system (interest based). The other MFIs that operate based on the Islamic system (*Shari'ah*) include BPR *Shari'ah* (BPRS) and BMT (*Baitul Mal Wat Tamwil)* (Ismawan and Budiantoro, 2005; Widiyanto, 2007). To adequately explain the functions of the MFIs, the researcher is always faced with secondary data, which are not readily available because there is not a single central body that can collect, process, and disseminate the MFIs data for updating purposes at the moment (Sebel and Agung, 2008). The Islamic microfinance institutions (IMFIs) are one of the MFIs groups that has the fastest growth rate among the MFIs in Central Java. IMFIs consist of two institutions:

i) Bank Perkreditan Rakyat (BPRS/ syariah rural bank) and

ii) Baitul Mal Wat Tamwil (BMT).

BMTs are important new sources for the establishment of micro institutions. While gaining support from the Islamic community they have also rapidly spread the establishment of microfinance institutions in Indonesia. Obviously, there are some Muslims in Indonesia who would never use the conventional banking services. This is because these MSMEs use interest that is not in accordance with the Islamic value. Therefore, the establishment of BMT becomes one of the alternative ways to solve the problem of the lack of capital (Widiyanto, 2007). BMTs are a grass-root development supported by funds from the Islamic community members. These micro-finance institutions usually operate on the principle of profit-loss sharing and they use the Islamic moral values and group solidarity as social capital to encourage repayment of loans (Sakai and Marijan, 2008). Group solidarity has been fostered through regular meetings and counseling. Hence, this study will focus on BMTs that can produce a big impact on the practice of the Islamic microfinance in Central Java. Currently, BMTs are an important part of the micro-enterprises development in Central Java. Thus, in this study, the term BMTs and IMFIs are interchangeably used.

The word Baitul Mal Wat Tamwil (BMT) comes from two terms, i.e., *baitul mal* and *baitul tamwil* (Azis, 2008). As such, a more specific definition can be derived as follows:

1. *Baitul mal* means “the house of wealth” which refers to the social mission of BMT as an institution that distributes the donation of *zakat, infaq,* and *shadaqah* to the persons who are eligible to receive (*Mustahiq*).

2. *Baitul tamwil* means “the house of wealth development”, which is the business mission of BMT. It is meant to conduct business development efforts and investments in productive economy in order to improve the quality of micro and small entrepreneurs, especially, by encouraging saving activities and supporting the financing of economic activities.

BMTs operate under cooperative principles, which are regulated under the cooperative law of Act No. 25/1992. They are registered with the Ministry of cooperatives, small and medium enterprises, but not all BMTs operate as legal entities. The establishment of BMT has to be attested by a notary and BMT statutes are standardized. They include subjects such as identity, area of operation, objectives, and transaction under profit-loss sharing principle and using the Islamic moral values as guidance in the transactions (Sakai and Marijan, 2008). The profit and loss sharing system embraces: trustee financing (*mudharabah*) and partnership financing (*musyarakah*) while the trade financing system includes: markup financing (*murabahah*), deferred payment sale financing (*bai’u bithaman ajil*), leasing (*ijarah*) and benevolent loans (*qard al hasan*) (Seibel and Agung, 2008; Sakai and Marijan, 2008).

As a viable financial institution, BMT offers products and services similar to the Islamic banks and syari’ah rural banks (BPRS). However, it has a different market sector in terms of patronage, where the Islamic banks mainly cater for the middle class and the white collar Muslims. BPRS on the other hand mainly provides services for Muslims from the middle and the lower income groups. While BMT usually serves the Muslim customers who run small and medium enterprises and whose access to the banks is relatively limited, some customer overlapping occurs among the Islamic bank, BPRS and BMT (Sakai and Marijan, 2008). According to Yumna and Clarke (2012), the main features of BMT are:

1. Providing adequate services for the extremely poor clients and transferring some of them to the economically active poor clients.
2. It is possible to create a sustainable microfinance since it does not only depend on the donor fund to provide the microfinance.
3. It increases the accountability of both institutions since they need to report to zakat and Islamic charities payers and its potential payers, shari'ah compliance finance as well as the microfinance institution supervisory board.
4. It will create sustainable microfinance with lower default rate and reduce the possibility of misuse of the loans since the microcredit is only for the skilled people who conduct some income generating activities.
5. It will reduce the agency problems since both institutions engage in the same value and objectives.

2.2. Islamic Microfinance and Poverty

Microfinance can be a critical element of an effective poverty reduction strategy especially for developing countries. To redress the issue, the policy of increasing access to both production and consumption credit by the poor has been articulated. The services provided by microfinance institutions can enable the poor to smoothen their consumption, manage their risks better, build their assets gradually, develop their micro enterprises, enhance their income earning capacities, and enjoy an improved quality life of poor people (Kessy and Urion, 2006; Gebru And Paul, 2011).

Poverty is defined by several authors as the situation of having not enough money to meet the basic need of human beings. Englama and Bamidele (1997) define poverty as a state where an individual is not able to cater adequately for his/her basic needs of food, clothing and shelter, meet social and economic obligations; lacks gainful employment, skills, assets and self-esteem; and has limited access to social and economic infrastructures (in Okpora, 2010).

Hassan (2010) notes that the Islamic approach to poverty alleviation ideally involves comprehensive approaches including (a) increasing income levels with pro-poor programs, (b) achieving an equitable distribution of income and (c) providing equal opportunities for all social segments. The most important constraint that poor people face to come out of poverty is lack of access to credit to run their own businesses. One of the identified key constrains facing the poor is lack of access to formal sector credit to enable them to take advantage of economic opportunities to increase their level of output, hence move out of poverty (Gebru and Paul, 2011).

The researchers have proved that microfinance as one of the contributors in reducing poverty through increased income and standard of living, empowering women, developing the business sector, developing a parallel financial sector, improving quality of women's life, and also improving health care and education (Kessy and Urion, 2006; Gebru and Paul, 2011; Okpora, 2010; Shirazi and Khan, 2009 and Durrani et al, 2011).

Studies have also been conducted to quantify the impact of microfinance on poverty alleviation. Hulme and Mosley (1996), for instance, based on the counter factual combined approach, analyzed the impact of microfinance on poverty alleviation using sample data from Indonesia, India, Bangladesh and Sri Lanka. They found that growth of borrowers' income always exceeds that of control group and that increase in borrowers' income was larger for better-off borrowers (in Shirazi and Khan, 2009).

The study conducted by Khandker (1998) in Bangladesh focused on Grameen Bank, and Bangladesh Rural Advancement Committee (BRAC). He found that microfinance alleviated poverty up to 5 percent annually (in Shirazi and Khan, 2009). Moreover, Rena, Ravinder and Ghirmai (2006) found that microfinance is the founding stone for poverty reduction. They showed that there is a fundamental linkage between microfinance and poverty eradication (in Durrani et al, 2011).

Similar studies have also been done in other countries. Gurses (2009) conducted a study in Turkey and mentioned that microfinance, especially micro credit, is a powerful tool to reduce poverty. In Pakistan, Shirazi and Khan (2009) examined the impact of micro credit on poverty alleviation. They divide poor into two categories: the poor and the extreme poor. They found that Micro credit had reduced the overall poverty level by 3.07 percentage points. The poverty status of the extremely poor borrowers had been marginally increased by 0.63 percentage point.

However, in Thailand, Coleman (1999) studied the role of Thailand village banks on poverty. He found no evidence of any impact of microfinance on poverty. Another study by Coleman (2004), found that programs do not reach the poor as much as they reach relatively wealthy people (in Shirazi and Khan, 2009).

A similar study was also conducted on Islamic microfinance by Akhtar, Akhtar and Jafri (2009). They found that Islamic microfinance is one of effective ways to fight poverty. The authors mentioned that in the Muslim world, the conventional micro finance could not be fruitful because of the Islamic social principles. Most of the people prefer Islamic microfinance rather than the conventional microfinance (Durrani et al., 2011). Chowdhury and Bhuiya (2004) examined the impact of credit programme on the Bangladeshi borrowers under the BRAC projects and found positive impacts on human well-being, survival rate and schooling of children.

Based on the above discussion, the following hypotheses are discernable:

H1. Islamic microfinance has significant role on income improvement.

H2. Islamic microfinance has significant role on education.

H3. Islamic microfinance has significant role on health care.

H4. Islamic microfinance has significant role on business progress.

3. RESEARCH METHOD

3.1. Sample

This study was conducted to examine the effect of Islamic microfinance on poverty alleviation. This study used the sample of *Baitul Mal Wat Tamwil* (BMT), as the Islamic microfinance institution in Indonesia. A total of one hundred fifty borrowers from 20 BMT in Demak and Kudus regencies, Central Java were taken into consideration. The questionnaires were distributed among the lower borrowers using purposive sampling method. Out of 150 distributed questionnaires, the researchers received back 124 responses. The questions relating to the effect of microfinance on income, education, health care, and business progress were asked. Five options were given to the respondents for filling the questionnaire such as strongly agree, agree, neither agree nor disagree, disagree and strongly disagree. The Table 3.1 shows the demographic characteristics of respondents.

Table 3.1. The Characteristics of Respondents

Demographic Variables	Frequency	Percentage
Gender		
Male	65	52
Female	59	48
Total	124	100
Age		
20 - 30	58	47
31 - 40	34	27
41 – above	32	26
Total	124	100
Education Level		
No Education	25	20
Primary	39	31
Secondary	53	43
Post Secondary	7	6
Total	124	100
Profession		
Entrepreneur	58	47
Farmer	41	33
Worker	25	20
Total	124	100
Loan Amount (Million Rupiah)		
Lest than 1	10	8
1 – 3.5	58	47
3.6 – 5	56	45
Total	124	100
Income (Million Rupiah)		
Lest than 1	35	28
1 – 2	62	50
More than 2	27	22
Total	124	100
Time with BMT (year)		
1 – 2	64	52
2 – 5	49	39
More than 5	11	19
Total	124	100

From Table 3.1, one can deduce that about fifty two percent (52%) of the respondents are male; fifty-eight respondents representing forty seven percent (47%) are between the age of 20-30. With regards to educational background as shown in the table above, 20% had no formal education, 31% had primary level, 43%, forming the larger group, had secondary level and the rest post secondary level of education. In terms of occupation, the majority of respondents (47%) were entrepreneurs; farmers forming the second largest group of 33%, and the rest were workers.

In terms of loan, the study analyzed the loans granted to individuals on three different scales, less than 1 million rupiah, between 1 to 3.5 million rupiah and between 3.6 to 5 million rupiah. The majority of loans granted, around 47% (58 respondents), are between 1 to 3.5 million rupiah, which implies that IMFIs basically focus on micro-credits. Regarding time with Islamic microfinance, the majority of respondents (52%) were already with Islamic microfinance between 1 and 2 years.

3.2. Measurement

The questionnaire comprised of the questions about background information such as gender, age, education, number of loans, income per month, and time with Islamic microfinance. Besides demographic information of the respondents, 18 different questions were asked about the microfinance and its effects on reducing poverty. The items for the said scale are adapted from a number of relevant research studies (Durrani et al. 2011, Hassan, 2010; Shirazi and Khan, 2009; Ali, and Alam, 2010; Akhtar, Akhtar, and Jaffri, 2009).

3.3. Analysis

The data were analyzed using SPSS 15.0 software. The analysis included descriptive statistics such as frequencies and percentage to present the main characteristics of the sample. For testing the hypotheses, this research used simple regression analysis as the main method of analysis. Here, we examined the role of Islamic microfinance on income, education, health care and business progress one after the other.

4. RESULTS

Table 4.1 displays the mean, standard deviation, standard error mean and correlation for four variables: role of Islamic microfinance, education access, health care, income and business progress. The correlations among the variables provided initial support for three proposed hypotheses, only health care was not significantly correlated with the role of Islamic microfinance.

Table 4.1. Mean, Standard Deviation, and Correlation

No	Variable	Mean	S.D	1	2	3	4
1	Role of IMF	4.5	.39	1			
2	Income	4.2	.40	.219*	1		
3	Education	4.4	.36	.394**	.309**	1	
4	Health Care	4.4	.36	.050	-.016	-.130	1
5	Business Progress	4.3	.41	.636**	.439**	.330**	.267**

**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

To address the purpose of the study, the proposed hypotheses were tested using regression analysis. The results of regression analysis are summarized in table below:

Table 4.2. The results of Regression Analysis

Variables	Independent Variable Role of Islamic Microfinance (IMF)		
	R^2	F change	B
Income	.048*	6.16*	.219*
Education	.155**	22.37**	0.394**
Health Care	.002	0.303	0.05
Business Progress	.405**	82.90**	.636**

Note: ** $p < 0.01$, * $p < 0.05$

To test the first hypothesis, the study regressed the role of Islamic microfinance on income. The relationship between the role of Islamic microfinance and income is significant, as indicated in Table 4.2 (R^2 = .048, $p<0.05$). The null hypothesis is therefore rejected. Role of Islamic microfinance explained the income's variance about 4.8% (F=6.16, $p<0.05$) in income. The second hypothesis was also supported, as indicated by $R^2 = 0.155$, $p < 0.01$ (see Table 4.1), therefore null hypothesis is rejected. The role of Islamic microfinance explained about 15.5 % of family education variance. The third hypothesis is not supported. The role of Islamic microfinance on health care is not significant. The null hypothesis is therefore accepted. For the last hypothesis, the study regressed role of Islamic microfinance and business progress. The result shows that Islamic microfinance has a significant role on business progress (R^2 = 0.405, $p < 0.01$). Therefore, the null hypothesis is rejected.

5. DISCUSSION

The results of the study demonstrated that the role of Islamic microfinance has a strong relationship with income, education, and business progress. However, the role of Islamic microfinance shows no significant effect on health care.

For the first, second and fourth hypothesis, the results indicate that the relationships between the Islamic microfinance and income, education and business progress are positive and significant. These are in line with the prior research (Shirazi and Khan, 2009; Durrani, et al. 2011; Gebru and Paul, 2011; Okpara, 2010; Kessy and Urio, 2006), which demonstrated the positive role of microfinance on income, education and business progress. The result suggested that the Islamic microfinance plays an important role on improving income of household, improves access to children's education and also supports improving business for poor people. The findings are in line with the previous studies conducted by Akhter, Akhtar, and Jaffri (2009). They found that interest free loans could be used as a powerful tool against poverty. The study, however, recommends integrating Islamic Microfinance with NGOs, Zakah, Awqaf and Takaful, along with professional training and capacity building Institutions.

Interestingly, the third hypothesis, however, is not supported since the result of the study indicated that the role of Islamic microfinance on health care is not significant. This finding was supported by Tiruneh (2006) who reached a similar finding. This result indicated that Islamic microfinance has no direct impact on health care. This situation could be attributed to one of these reasons: firstly, Central Java Authority gives insurance for the poor (Asuransi kesehatan Masyarakat Miskin/Poor Health Insurance), so, they do not need money to visit doctor or hospital. Secondly, traditionally, the poor people do not go to hospital or doctor for the medical treatment; they rather use alternative traditional medicine. Therefore, they do not need much money and that could be the reason why Islamic microfinance has no effect on poor health care in Central Java, Indonesia.

6. IMPLICATIONS AND LIMITATIONS

The finding of this study has some important implications. It offers some interesting guidelines for policy makers in Islamic microfinance. Firstly, Islamic microfinance has significant contribution on poverty alleviation especially its impact on income, education and business progress. Therefore, Muslim society should support these institutions. Additionally, Indonesian government should support the Islamic microfinance by proving additional fund to expand the role of Islamic microfinance on poverty reduction. Finally, the government should provide training and development on Islamic microfinance. The ability of Islamic microfinance staff to manage their organization will significantly improve the role of Islamic microfinance on poverty reduction.

Finally, the contribution of this study should be viewed in light of some limitations. First, the design for this study was cross-sectional, not longitudinal. Cross-sectional data are not adequate to make inferences of causality or reverse causality among the investigated variables. Thus, a longitudinal research design would provide additional and stronger support for the effects tested in this study. Second, the generalizability of the findings of the present study might be questionable due to the nature of the sample. Third, another shortcoming of this study is the limited numbers of variables; therefore, the next study should incorporate some variables which measure poverty precisely.

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