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Sustainable Development and Infrastructure

An Islamic Finance Perspective

Amadou Thierno Diallo
Ahmet Suayb Gundogdu

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God gives wisdom to anyone whom He wants. Whoever is given wisdom, certainly, has received much good. Only people of reason can grasp this.
2:269

Preface

Most books on Islamic finance and development issues are written from an academic perspective. Although academic reflection is key for future direction, dissatisfaction with development efforts, as evidenced from failure of sustainable development efforts, suggests the need for a different look. Development work has many details and a folded approach would not lead to cogent resolution of protracted issues. Each intervention area requires specific elaboration for meaningful impact. What is perfectly correct for one sector might be detrimental for another.

Millennium development goals (MDGs) were a good start in framing sustainable development with clear objectives to interlink different areas of development work in pursuit of poverty alleviation, income inequality, and hunger. Their successor sustainable development goals (SDGs) built on lessons learned from MDGs. The major obstacle to achieving SDGs is very often stipulated as the need for massive resource mobilization to carry out interventions. The effectiveness of interventions, however, is never questioned. Since interventions are stunted so are efforts for resource mobilization: no one wants to waste resources for abortive projects. The general impression is that the resources allocated are wasted with the unfair enrichment of the few in the process of carrying out barren projects. Historical focus has been on project outputs in the form of project assets, assuming that any infrastructure development would provide an enabling environment for growth. The assumption has been that the economic growth will happen by itself through the trickling-down effect for employment, poverty alleviation, income inequality, and hunger. Regardless of a string of economic growth years, however, the issues are still there and this leads to the questioning of the validity of assumptions. An economic growth approach for sustainable development does not work. The idea of inclusive growth emerges to address the missing link. However, even this inclusiveness idea alone, despite its ability to touching upon an important missing link, is not enough. A more holistic approach is needed to understand the role of finance in sustainable development and infrastructure projects. More importantly, focus should be on outcomes: a link between project outputs and desired sustainable development outcome needs to be established during project formulation. In order to achieve the desired outcome for sustainable development, financing is an important tool. It should be utilized subtly and skillfully vis-à-vis infrastructure projects.

Islamic finance, with its strict Riba restrictions, rules, and other checks and balances, is a very good fit for infrastructure development in pursuit of sustainable development. When it comes to sustainable development, Islamic finance has enough tools to intervene for impact. However, the success of developmental projects is not only related to Islamic finance—where more policy discourse is needed—but also requires guidance from the principles of Islamic economics. This book intends to elaborate on a different aspect of infrastructure development vis-à-vis sustainable development, drawn from decades of real-life development banking experience, and to propose impactful intervention methods based on wisdom from both Islamic economics and finance.

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CHAPTER 1

Islamic Finance for Sustainable Development Goals

Islamic finance practitioners and scholars are drawn toward the sustainable development goals (SDGs) of the United Nations because the goals are perfectly aligned with the philosophy of Islamic finance. Scholars reflect on the role of Islamic finance as a reemerging financial alternative in the context of SDGs. Often the profit–loss sharing arrangement of Islamic finance, its solidarity-based feature for poverty alleviation, and its use of *Sukuk* for resource mobilization to finance infrastructure development are highlighted.[1] In the context of SDGs, it is key to link Islamic financial institutions and capital markets to address the vulnerability of the poor, financial stability, and development. The critical component for achieving SDGs is resource mobilization, and this is a key focus of the developmental agenda for 2015–2030. The SDG programs to achieve the given targets require unprecedented resource mobilization compared with their predecessors, the programs of the millennium development goals (MDGs), which focused on a limited number of targets.[2] Therefore it is vitally important that we examine the potential role that Islamic finance can play in the effort to support the resource mobilization for SDGs. If we examine the academic research in this area, we see that it offers

[1] Zarrouk (2015).

[2] Ahmed et al. (2015).

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only limited insights. This is because there has been little opportunity for scholars to obtain hands-on experience of the practice of Islamic developmental finance as there is still a gap to be bridged between academic research and hands-on real-life practice.

The conventional understanding of economics and finance with SDGs is now converging to that of Islamic as finance is not instrumental anymore, but a means to achieving sustainable development. What differs in Islamic finance is related to the underlying financing contracts but more importantly with the wider economic perspective. Finance is a tool that can be used to achieve *Maqasid Al Shariah* in Islam. Although there are key differences between sustainable development goals and the classical definition of *Maqasid Al Shariah*, the philosophical convergence toward Islamic conventions encourages the need for a joint effort. However, there still exist major underlying distinctions: (1) the Islamic definition of poverty is net worth-based while SDGs assume an income approach. From an SDG viewpoint, a person with high levels of debt is not categorized as poor as long as such debt generates income. During the cycle of loan growth that feeds accelerated economic activity, poverty statistics substantially improve. However, once the circle is broken, in a very short period poverty numbers will explode as income depends on uninterrupted economic activity while debt is outstanding; (2) Islamic philosophy stands for fairness and harmony among humans. Every person is created with particular attributes to form a harmonious human collective. In Islam, everybody is equally valuable, yet unique and different; (3) the Islamic approach proposes matching noninterest-based financial products, in lending and resource mobilization, to address the peculiarities of intervention areas: there is no one-size-fits-all product.

The practice of Islamic development suggests the key success factor as the ability to harness the right blend of resource mobilization tools – namely grants, concessional loans, and commercially priced loans – with the most effective programs. It is most important to match development programs with the correct resource mobilization methods and platforms. Many of the proposals for the harnessing of *Zakat*, *Waqf*, and *Qard Hasan* fail to consider real-life implications. In many instances these tools are proposed for intervention areas interchangeably.[3] Contemporary hands-on approaches and appropriate Islamic resource mobilization interventions for SDG programs are shown in Table 1.1.

The essence of the Islamic poverty alleviation approach is to provide a blend of resources to encourage cooperation among the active poor as opposed to competition in a zero-sum game. The aim is to generate added value within the value chains to tackle the issue of poverty in rural areas before the poverty migrates to urban areas. Once poverty is transformed into urban areas, it is much more difficult to manage: migrants may not develop the skills that are needed quickly enough to add value to an urban economy. Hence, experience shows that if a microfinance program is designed properly in terms of profit–loss sharing with Islamic finance products, it can tackle the original issue: rural poverty.[4] In particular, the group purchase of raw materials and the sale of products as a group give substantial bargaining power to farmers and microfinance institutions. It is then possible to achieve high profit margins. In such cases, an economic empowerment fund can help to alleviate poverty.

In the following three sections we shall examine the three interventions for resource mobilization (in Table 1.1) in relation to Islamic finance.

1.1 Commercial Resources for Islamic Microfinance and Economic Infrastructure Development

With commercially priced loans (see Table 1.1), the funds returned to fund providers by beneficiaries/borrowers consist of the principals plus the market markups. The purpose of such loans is to create an enabling environment through financial inclusion. Some scholars have proposed offering interest-free loans (*Qard Hasan*) to the poor; however, the returns of commercially priced loans are based on market rates to ensure value addition for the investments.[5] Further, as a finance strategy to generate economic activity, grants and concessional loans mislead an economy and allocate resources to inefficient transactions. In order to assure value addition, such programs should be used with market rates.

[3] Gundogdu (2019).

[4] Wilson (2007).

[5] Elgari, M. A. (n.d.) The Qard Hasan Bank. Mimeo.

Table 1.1 Development programs, SDGs, and resource mobilization.

Islamic resource mobilization		*SDGs*	*Programs*
1. **Commercially priced loans**: Islamic finance modes (funds returned from beneficiaries of finance, principals plus market markups, to fund providers)	Economic empowerment funds Developmental *Waqf*	SDG #1: No poverty	Economic Empowerment Program: Islamic Microfinance in value chain
	1. Investment *Sukuk* 2. Two-step *Murabaha/Musharaka*	SDG #7: Affordable and clean energy SDG #9: Industry innovation, and infrastructure SDG #8: Decent work and economic growth	1. Public–private partnership 2. Small and medium-sized enterprise line of financing
2. **Grants**: *Zakat* (direct transfer of funds from the rich to the poor; neither principals nor markups go back to fund providers)	*Zakat* platform	SDG #2: Zero hunger SDG #5: Gender equality SDG #10: Reduced inequalities within and between countries	1. Support for microfinance beneficiaries to eradicate hunger 2. Wealth distribution programs as opposed to social transfer, food stamps, and social security systems

Islamic resource mobilization		*SDGs*	*Programs*
3. **Concessional loans**: *Qard Hasan* (funds returned with principals plus market markups; markups spent on programs for beneficiaries, with the principals returned to the fund providers)	Complementary Currency Cash *Waqf* /Cash *Waqf Sukuk*	SDG #3: Good health and well-being SDG #4: Quality education SDG #6: Clean water and sanitation SDG #11: Sustainable cities and communities	Flagship programs related to social investment

Source Based on Gundogdu (2018)

Contrary to the commonly held belief, poor people can be a source of sustainable economic growth if they are endowed with an enabling environment. Economic empowerment is an integrated approach of Islamic finance that excludes no one. Its purpose is to invest with the poor and undertake economic activities, using Islamic financing formats, with low-income marginalized groups, unemployed youth, and productive families.

The concept of economic empowerment has been applied in several countries and has yielded some very encouraging results.[6] It is more profitable and less risky for all parties: fund providers, fund users, and communities. It is very effective at combatting poverty and achieving social security and development because its economic projects are more stable and resistant. The basis of the concept is that fundamental barriers exist that must be lifted to help eradicate poverty and integrate the poor into value chains so that they can achieve self-sustenance. Accordingly, economic empowerment through Islamic microfinance assumes that the essential needs of the poor are multidimensional. In other words, poverty has several facets and financing is just one of them. Poverty has more to do with the inability to take advantage of certain enabling factors: project opportunities, economies of scale to compete with large producers, networks for market access, fair price formation, and, most importantly, supportive infrastructures.[7]

Economic empowerment is indeed an Islamic microfinance program; however, for several reasons, it is not called Islamic microfinance as such. The philosophy behind the concept of economic empowerment is to address problematic issues with microfinance, whether such finance is Islamic or conventional. Unfortunately, though, microfinance lending programs very often defeat their purpose. Poor people become worse off because microfinance institutions (MFIs) run businesses for profit once the system proves that they are viable. MFIs prey on the poor by lending

[6] The Islamic Development Bank's results have been impressive for Palestine, Sudan, Yemen, Kazakhstan, and Benin.

[7] A supportive infrastructure involves the creation and supply of economic zones, industrial zones, warehouses, generators, water purification units, incubators, packaging centers, laboratories, and other projects that cannot be provided by one initiative but can be achieved within the framework of unions, cooperatives, and solidarity groups. One of the objectives of these supportive projects is to ensure that initiatives for the economic empowerment of the poor have the same chance of success as large and medium enterprises in the private sector.

money without considering value addition in enterprises and by fueling competition in communities. In some instances, MFIs charge up to 200 percent interest by subtle deceit. For example, they ask for US$1 return per day, compounding such a repayment until it reaches 200 percent interest per annum. The financially illiterate poor do not understand such a calculation.[8]

In order to generate value addition for the poor, the economic empowerment concept focuses on value chains and encourages group cooperation rather than competition. Experience shows that the agricultural sector supports value addition; however, the informal urban employment sector, which fuels zero-sum game competition, does not. MFIs adopt microfinance beneficiaries as business partners, buy agricultural input goods for all farmers at a discounted price, and act as offtakers during harvests in order to sell the farmers' produce in bulk for higher prices. Such an approach can generate a 20 percent margin for input purchases and a 20 percent margin for the sale of harvests. The farmers are no longer susceptible to exploitation because of such intervention. For this reason, by participating in microfinance programs, farmers are better off. Even after paying a 15 percent markup on financing, they still have a 25 percent margin. Besides, the concept has ancillary benefits such as group training and bulk storage. Indeed, this model can be expanded to other supportive infrastructures in order to support value chains. Further, microfinance programs can be supported by *Zakat* to avoid the use of microfinance loans by farmers for food. The use of loans for food is one of the main reasons why microfinance interventions fail. The poor very often spend microfinance loans on food out of desperation. Thus, the poor default on their loans and are punished for the rest of their lives by financial institutions refusing them further access to funds. With the concept of economic empowerment, such drawbacks are addressed with *Zakat* money, if needed, in order to ensure that farmers can have food; thus, the farmers use their loans solely for their enterprises. However, unlike the proposal by some scholars to use *Zakat* to lend *Qard Hasan* to farmers, *Zakat* must be used in its traditional context and not for insuring farmers or bailing them out.[9] Experience has shown that after farmers become aware that the origin of their resources is *Zakat*, or there

[8] Sinclair (2012).

[9] Kahf (2004).