Is it Possible to Combine Waqfs and Zakat for Enhancing Entrepreneurship in the World of Islam?

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Abstract

Islamic civilization has created at least three powerful economic institutions, zakat, waqf, and mudaraba, that can be employed contemporaneously to attack the problem of poverty. However, mainstream Islamic economics has considered each of these institutions separately. This article combines all three with the purpose of enhancing entrepreneurship, which is one of the most potent components of economic growth and development. A combination of zakat, waqf, and mudaraba is possible, however, only if deemed permissible by Shari'a law. This article shows that contemporary Shari'a authorities have permitted the transformation of zakat funds into waqf funds. As for investing waqf funds via mudaraba, that was permitted by Imam Zufar back in the eighth century, as well as by modern authorities. In short, there is no Shari'a obstacle to the combination mentioned. This article aims to facilitate the combination and thus enable Muslims to support their entrepreneurs with substantial funds.

Keywords: *zakat, waqf, mudaraba, entrepreneurship*

Of the three economic institutions mentioned in the abstract, even though zakat and waqf are well-known, this article begins with brief descriptions in order to clarify the essential differences between the two. Mudaraba will be considered later on.

Zakat is one of the five pillars of Islam and is an obligation for every Muslim whose annual income is above a certain minimum. It differs from conventional taxation in that it can also be paid voluntarily. It can be paid in cash and can also be paid in kind at the usual rate of 2.5% or one fortieth of one's accumulated wealth. Zakat can be paid to eight categories of recipients.

Waqf, on the other hand, is a charitable or even philanthropic foundation voluntarily established by the well-to-do. There is definitive evidence that waqf-like institutions existed in pre-Islamic societies (Borgolte, 2017; Duncan-Jones, 1982). Continuity and change from these pre-Islamic institutions into Islamic waqfs are also well known. It is generally

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accepted that various statements of the Prophet Muhammad gave Islamic foundations their special characteristics (Çizakça, 2000, 6; 2021).

At this point, one wonders about the relative importance of these two institutions in the economy. At least one eminent historian had long ago argued that although zakat had been the "original vehicle for financing Islam as a society" and continued as a main justification for a Muslim government's various taxes, waqfs eventually assumed a greater role in financing most public institutions (Hodgson, 1974, Vol. II, 124). The relatively greater role of waqfs in the economy was recently confirmed by a contemporary Islamic economist who reached the conclusion that "only waqfs can alleviate the poverty in the case of Indian Muslims." The same author also observed that no Islamic country had yet combined "zakat and waqf as part of their poverty reduction strategy" (Shirazi, 2014, 94, 96). This article addresses precisely this issue and presents a model by which Muslim countries can alleviate poverty by combining three potent institutions: zakat, waqf, and mudaraba, as explained in the following section.

The Model

This model is based on the premise that millions of zakat-paying Muslims exist in all Muslim countries and that the goal is to effectively mobilize these funds for poverty alleviation and economic development by enhancing entrepreneurship. This premise invites the question: why entrepreneurship is so important? The argument herein is that each newly established firm by an entrepreneur, a start-up, will create employment, introduce new technology, produce goods or services that can be supplied domestically or exported and thereby earn precious foreign exchange. Each person employed by a new-born firm means new taxes paid to the state and increased supply and demand for all products in the economy, in short, a reduction in poverty.

But how can zakat collection be directed to private start-up firms? After all, we are talking about funds paid by millions of people. To channel these funds to a handful of firms efficiently and without corruption is a momentous task. It is obvious that neither the government bureaucracy with its well-known weaknesses of inefficiency and corruption nor conventional banks obsessed with risk minimization are well suited for this task. A highly specialized waqf, functioning like a quasi-venture capital company enters the picture here.

This model envisages a waqf, or several waqfs, established by a number of philanthropists with the sole purpose of enhancing entrepreneurship. Put differently, the primary purpose of these waqfs is to finance young and promising entrepreneurs who want to establish their own firms, Start-Ups. Assuming that the entrepreneurs are chosen correctly, each successful newly born firm will provide the economy with the previously mentioned advantages. Each waqf that facilitates the birth of a new firm can be imagined as a fertile mother who gives birth, not to children but to firms.

Excluding the government due to its inefficient bureaucracy and inherent potential for corruption invites the question—can zakat funds be collected by a waqf? Whether a zakat fund can be transformed into a waqf fund was recently answered in the affirmative by Jasser Auda, executive director of the Maqasid Institute in London. According to Auda "Why not? There is no evidence from the Shari'a that zakat cannot be given to an endowment that achieves the same objectives and intents of the zakat itself and benefits the same category of receivers of zakat".

The pertinent category here, according to Auda, is "in God's cause." Thus, spending zakat funds on buildings, books, teachers, students, computers and related expenses also comes under the category of legitimate zakat receivers, specifically under the category of "In God's cause" (2022, 1). The recipient, say a third-year engineering student working on a promising project under his professor, that is, a potential entrepreneur, does not even have to be poor (El-Kardavi, 1984, ii, 24-27). Moreover, the Islamic Fiqh Academy officially permitted

investment of zakat funds by the receiving organizations (in this context the specialized waqf) at its third council in Amman in October 1986. Referring to this permission, Auda has stated that there are two conditions: first, the urgent needs of the poor and needy must not be compromised. Second, precautions must be taken so that the zakat funds are not lost in the investment process (Auda, 2022:3). Concerning the first, I would argue that there is no such compromise, on the contrary, as entrepreneurs are financed and establish their new firms, they begin to employ the poor and the needy. The latter then "graduate" from being zakat recipients to zakat givers. This is a highly desired form of zakat as recommended by Imam Shafi'i (El-Kardavi, vol. ii: 42). As for the second condition, it goes without saying that the waqf should conduct a thorough process of due diligence in selecting the right entrepreneur. If it is not equipped to do so, then it can outsource this work to specialized agents/companies.

Finally, if notwithstanding the above, there are still concerns about the safety of the zakat funds, the waqf can invest its funds in the most conservative way such as real estate and invest only the usufruct, that is the rents, it obtains from tenants.

This brings us to the twin questions of whether (a) a cash waqf is legitimate and (b) if so, how it can invest its funds?

The legitimacy of cash waqfs as well as waqfs of stocks has been thoroughly examined and answered affirmatively based on verdicts of the most important classical jurists. Moreover, such waqfs are now wide-spread in the Islamic world (Çizakça, 2000, 28–42, 63– 68).

As for the question of how such waqfs should invest their money, this was answered back in the eighth century by Imam Zufar on the condition that it is invested through mudaraba (Çizakça, 2000, 38), which is exactly what is envisaged in this article.

Based on the preceding information, we can now draw a number of conclusions:

- A waqf established with cash or stocks is legitimate.
- On the condition that the ultimate purpose of a waqf coincides with one of the categories of zakat recipients as indicated by Shari'a, it is permissible for zakat funds to be paid to a waqf.
- One of these categories is the "needy." Entrepreneurs needing financial support to buy machinery or expensive equipment for research or to transform their results into practical application are obviously needy.
- These entrepreneurs do not have to be poor. Indeed, even well-to-do entrepreneurs need substantial funds to do R&D and machinery to put their research results into practical application.
- If the entrepreneur is a young person, say a brilliant third-year engineering student with an excellent project, they would not be supported by conventional banks that insist on substantial collateral as well as a profitable balance sheet from some years back.
- In literature, this is known as the MacMillan Gap and is fulfilled by specialized venture capital companies usually concentrated in Silicon Valley in California or in the U.S. East Coast cities like New York and Boston.

The basic premise of this article is that specialized waqfs established with the purpose of financing young entrepreneurs and supported by massive zakat funds, can act as powerful quasi-venture capital enterprises in the Islamic world. The preceding arguments make clear that there is no Shari'a impediment to this model, the modus operandi of which now follows.

Modus Operandi

Consider a Muslim who decides to donate his/her annual zakat to a specialized waqf as described above. Nothing stands in the way of aggregating this behaviour and envisaging thousands of zakat-paying Muslims donating their zakat payments to the same waqf. The waqf aiming to finance young entrepreneurs has now become cash-rich. The challenge of the waqf now is to select the most promising entrepreneurs with the greatest profit potential. In similar fashion to Western venture capital firms, the waqf focuses purely on the feasibility and profit potential of the entrepreneur's team and project. A fiercely competitive process of due diligence, which ranks all the projects submitted, follows. The waqf differs from Western venture capital companies in that, while its profit share accruing from its investments is added to its original capital for reinvestment, the latter's profit shares are distributed to shareholders. Consequently, the potential for self-sustaining growth is much greater for the Islamic model.

This brings us to the next step: how the chosen entrepreneur will be financed. First, based on the fatwa of Imam Zufar mentioned above, the waqf is permitted to invest its zakat funds. So the issue becomes how the investment should take place. Because all loans or loan derivatives are usurious, they are discarded in this model. The waqf has two Islamic financial instruments that it can use to finance entrepreneurs: mudaraba and ʻInan partnerships. The former was practiced by the Prophet Muhammad and naturally enjoys impeccable legitimacy, while the latter is a derivative of the former. Since both partnerships are very well known, it is not necessary to explain them here. (Udovitch, 1970 and Çizakça, 1996). Suffice it to say that they are both profit-and-loss-sharing instruments. They also follow the dictum, which summarizes the profit-and-loss-sharing rule: profit follows mutual agreement, and loss follows capital. Because in a mudaraba partnership the entire pecuniary capital is provided by the capitalist partner, in this case the cash-rich waqf, it may incur loss. Profit, on the other hand, is distributed according to a predetermined ratio between the partners. In short, investing waqf funds via mudaraba is perfectly feasible and Shari'a-compliant. Moreover, a similar version of it, equity finance or its more specific derivative venture capital, is time- tested in the West.

There is one objection to all this: zakat funds collected in a waqf being invested via mudaraba, which is a risky instrument. Two things must be considered here. First, Western venture capital companies also make mistakes and sometimes finance the wrong entrepreneur. But experience has shown that even one profitable investment suffices to compensate for the losses of others. In this context, usually the ratio of one in ten is pronounced; that is, one profitable investment can compensate for the losses of nine others. This observation is used to define venture capital as a low probability of huge profit combined with a high probability of modest loss. Second, compared with Western venture capital, the Islamic model envisaged here has the added advantage that zakat funds that accrue to the waqf for investment are actually in the form of irrevocable donations. Thus, unlike a venture capital company (VCC), the waqf does not carry the risk of capital flight.

The above modus operandi can easily be aggregated to comprise thousands or even millions of zakat payers financing a multitude of entrepreneurs. Regardless of the number of people involved, the basic principles are the same.

Conclusion

Financing young entrepreneurs in the Islamic world is greatly needed. However, although the smallest firms can acquire seed financing from family and friends and well-established firms can obtain substantial funds from conventional banks, because of the MacMillan Gap, young entrepreneurs who need substantial capital are completely ignored by the system. It is, however, precisely these young entrepreneurs who hold the greatest economic potential because every new firm they establish will create new employment, supply new products, pay new taxes, export new goods, and earn precious foreign currency with which to finance imports.

This article proposes that all of the above can be done by Islamic countries applying well-known and authentic Islamic financial instruments. Combining zakat payments of the millions with specialized waqfs focusing on providing mudaraba finance to fledgling entrepreneurs appears to be a powerful financial instrument for Islamic countries.

Moreover, adding mudaraba/'Inan to the picture, the model provides patient capital to entrepreneurs. Conventional system based on credit to be paid back at a predetermined date insists on redemption regardless of the fate of the project. A zakat/waqf/mudaraba combination, by contrast, is a much more patient and entrepreneur-friendly capital. Indeed, zakat payments to the waqf are one-time donations and are never recalled. As the waqf transfers these funds to the entrepreneurs through mudaraba, the two become partners.

Mudaraba contracts neither impose a definite date of pay-back nor any predetermined amount of profit. These contracts merely insist that if profit is generated, it will be shared between the partners according to a predetermined ratio. A fixed profit amount cannot be imposed.

Moreover, the entrepreneur in a mudaraba agreement is not held responsible for a pecuniary loss. Furthermore, whereas in a Western venture capital company, profits are distributed among the shareholders and dissipate; in the Islamic model envisaged here, they accumulate in the nonprofit waqf and are directly added, minor some administrative expenses, to the original capital. In short, a zakat/waqf/mudaraba combination is not only truly Islamic, but may also be the most entrepreneur-friendly and self-sustaining financial system ever devised.

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