



EFFICIENCY AND GOVERNANCE OF ZAKAT
INSTITUTIONS IN MALAYSIA

BY

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A thesis submitted in fulfilment of
the requirements for the degree of Doctor
of Philosophy of Islamic Banking and Finance

Institute of Islamic Banking and Finance
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MAY 2013

ABSTRACT

Zakat is one of the five pillars in Islam. It is an obligation of the Muslims to give a specific amount of their wealth to the beneficiaries with the main objective of the achievement of socioeconomic justice. Zakat institutions are trusted bodies that manage zakat in Muslim countries. In Malaysia, State Islamic Religious Councils (SIRCs) is responsible in managing and promoting zakat. It is of prime importance that these institutions are being governed and managed efficiently and effectively. Efficiency is defined as how well a system is performing, in generating the maximum desired output for given inputs. Governance is defined as the process of decision-making and the process by which decisions are implemented or not. The governance of the institution is important in ensuring good management including efficient collection and distribution of the zakat funds. This study examines the relationship between efficiency and governance of zakat institutions in Malaysia. First, the study analyzes the efficiency of fourteen zakat institutions in Malaysia from 2003 to 2007. Efficiency is measured by the Malmquist index, using a Data Envelopment Analysis (DEA) technique. The Malmquist productivity measures are decomposed into two components: efficiency change and technical change index. The results show that zakat institutions in Malaysia are found to be experiencing an improvement of TFP which mainly due to technical change compared to the efficiency change which reflects that improvement in technological progress has been a major contribution of efficiency. Secondly, Tobit Analysis is utilized to determine factors that influence the efficiency of zakat institutions in Malaysia. Board size, number of meeting, audit committee, number of branches, number of staff, zakat payment system used, existence of computerized zakat collection system, existence of website, decentralization system and corporatization are examined as the determinants of the efficiency. The results indicate that the use of zakat payment system and decentralization significantly and consistently improve efficiency of zakat institutions in Malaysia. Third, a governance index based on the United Nation Development Programme (UNDP)'s principles of good governance is developed in evaluating the practice of good governance principles of zakat institutions in Malaysia. This study demonstrates that efficiency scores and adoption of good governance principles are highly correlated. Overall, the findings of this study show the importance of ensuring efficiency of zakat institutions in Malaysia. Findings of this study highlight the urgency for the relevant authorities such as Development of Zakat, Waqaf and Hajj (JAWHAR), SIRCs and the government to initiate efficiency improvement measures of zakat institutions in Malaysia. However, the role of the government in supporting and facilitating the institutions is highly desired. Cooperation among related authorities and the stakeholders for the betterment of the institution of zakat will be important to ensure the achievement of noble objectives of socioeconomic justice is attainable.

مُلخَصُ البَحْثِ

إنَّ الزكاةَ ركنٌ من أركانِ الإسلامِ الخمسةِ. فعلى المسلم أن يُخرِجَ قدرًا مُحدَّدًا من ثروته للمستحقين له علمًا بأنه في إخراجِ الزكاةِ تتحقّقُ العدالةُ الاجتماعيةُ والاقتصاديةُ. وفي الدول الإسلامية تم تكليف مؤسسات الزكاة بإدارة شؤون الزكاة. وأما في ماليزيا، يقوم مجلس الشؤون الإسلامية بالولايات الماليزية بإدارة شؤون الزكاة وتعزيزها. وانطلاقًا من ذلك فإنه من الأهمية بمكان أن تُدار هذه المؤسسات إدارةً حكيمةً رشيدةً وبكفاءةٍ وفعاليةٍ. إن الكفاءة تعني نجاح أداء نظام في توليد أقصى طاقة إنتاجية مرجوة باستخدام المدخلات المُعدَّة. وتعني الإدارة الرشيدة عملية صنع القرارات وتطبيقها وأدائها. وفي ضوء ذلك فمن الضروري إدارة مؤسسات الزكاة إدارةً حكيمةً لضمان الكفاءة في جَمْعِ الزكاة وتوزيعها. فنتناول هذه الدراسة العلاقة القائمة بين الكفاءة والإدارة الحكيمة لمؤسسات الزكاة في ماليزيا. وتقوم الدراسة أولاً، بتحليل الكفاءة لأربعِ عشرةَ مؤسسةً من مؤسسات الزكاة في ماليزيا في الفترة من 2003 إلى 2007. وتمّ قياس الكفاءة باستخدام مؤشر (مالكويست)، وأسلوب تحليل مغلف البيانات (DEA). كما تم تقسيم مقياس إنتاجية (مالكويست) إلى العنصرين: الأول مؤشر تغير الكفاءة، والآخر مؤشر التغير التقني الفني. وتشير النتائج إلى أن مؤسسات الزكاة في ماليزيا شهدت ارتفاعاً في الإنتاجية الكلية لعوامل الإنتاج (TFP) نتيجة التغير التقني الذي يدل على أن الارتفاع في التطور التكنولوجي هو العامل الرئيس للكفاءة. وتقوم الدراسة ثانياً، باستخدام تحليل (توبيت) للتعرف على العوامل التي تؤثر على كفاءة مؤسسات الزكاة في ماليزيا. وقد تم فحص الأمور التالية للتعرف على العوامل المحددة للكفاءة: عدد مجلس الإدارة، وعدد الاجتماعات، ولجنة المراجعة، وعدد الفروع، وعدد الموظفين، ونظام دفع الزكاة المستخدم، وتوفر نظام جمع الزكاة المحوسب، وتوفر الموقع الإلكتروني، والنظام اللامركزي، والخصخصة. وتشير النتائج إلى ارتفاع نسبة الكفاءة في مؤسسات الزكاة الماليزية بشكل ملحوظ ومستمر نتيجة استخدام نظام دفع الزكاة والنظام اللامركزي. ثالثاً، تقوم الدراسة بتطوير مؤشر الإدارة الرشيدة على أساس مبادئ الإدارة الرشيدة لبرنامج الأمم المتحدة الإنمائي (UNDP)، لتقوم بممارسة مبادئ الإدارة الرشيدة في مؤسسات الزكاة الماليزية. وأظهرت نتيجة البحث الارتباط المتبادل بين الكفاءة وممارسة مبادئ الإدارة الرشيدة. وبشكل إجمالي، فإن نتائج الدراسة تؤكد أهمية الكفاءة في مؤسسات الزكاة في ماليزيا. وتوصي الدراسة بضرورة قيام جميع الجهات المعنية بشؤون الزكاة مثل: إدارة الأوقاف والزكاة والحج، ومجلس الشؤون الإسلامية بالولايات الماليزية، والحكومة، بإعداد السبل والخطوات لتعزيز الكفاءة في مؤسسات الزكاة الماليزية. كما توصي الدراسة بأن تتعاون وتتضامن الجهات المعنية بشؤون الزكاة وأصحاب المصلحة لتحسين أداء مؤسسات الزكاة بعبء تحقيق الهدف الأسمى من إخراج الزكاة الذي يتمثل في تحقيق العدالة الاجتماعية والاقتصادية.

APPROVAL PAGE

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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To these special people whose endless love and support I can never repay;

*My husband:
ZAIRY ZAINOL*

*My parents:
HAJI ABD. WAHAB IBRAHIM
&
HAJJAH ROMIYAH BINTI KHALID*

*My children:
ZIHNI ILMAN
ZAHIN ZAYDAN
ZULFA FAIQA
ZAHRA ULYA*

ACKNOWLEDGEMENTS

In the name of Allah, the Most Gracious and the Most Merciful. Praise be to Allah, Lord of the Universe and to His Messenger, Muhammad PBUH.

First and foremost, am very grateful to Allah, the Almighty for giving me the strength, courage, peace and blessings to complete this study successfully. This work would not have been completed without the help of many individuals whose support has meant a great deal to me.

My special thanks go to my supervisor, Prof. Dr. Abdul Rahim Abdul Rahman. Without his wisdom, constructive comments, invaluable guidance and advice throughout the research, the accomplishment of this thesis would not have been possible. Indeed, it is a great desire of mine to use those valuable lessons, advice and guidance to be not only a researcher of high quality, but also a better person to all whose lives cross path with mine.

I am also grateful to Assoc. Prof. Dr. Mohd. Shabri Abdul Majid, Assoc. Prof. Dr. Norma Md. Saad and Assoc. Prof. Dr. Mohd. Akhyar Adnan for providing insightful comments and suggestions. I would also like to express my many thanks to the practitioners of zakat institutions who have providing me with data and information.

In addition, my sincere appreciation goes to my fellow colleagues with whom I have shared this journey. This special group of people includes Selamah Maamor, Suraiya Hashim, Aznita Samsi, Romzie Rosman, Ratna Mulyani and Faizah Abu Bakar; to name a few. The high and low moments that we have gone through together are the elements that would bind us to be good friends forever.

No words are adequate to express my deepest appreciation to my beloved husband, Zairy Zainol, for his never-ending love, encouragement, helps and supports during all these years. I express my deepest and most profound emotional appreciation to him during the period of my doctoral research, along with his endless support of my academic pursuits. I am most grateful for his unstinting belief in my ability to do research and his academic and emotional encouragement. To my wonderful children: Zihni, Zahin, Zulfa and Zahra; who wiped away my tiredness and giving me the inspiration to keep on going and complete this long journey. I thank my parents, siblings and in-laws for their unfailing love and support. Finally, from the bottom of my heart, to all who have contributed directly and indirectly to the completion of this study, thank you very much.

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LIST OF ABBREVIATIONS

ASEAN	The Association of Southeast Asian Nations
ATM	Auto-teller machine
BAZ	Badan Amil Zakat
BAZIS	Badan Amil Zakat, Infaq dan Sedekah
BERNAMA	The Malaysian National News Agency
BMM	Baitulmal Muamalat
CEO	Chief Executive Officer
CRS	Constant Returns to Scale
CSR	Corporate Social Responsibility
DEA	Data Envelopment Analysis
DFA	Distribution Free Approach
DMU	Decision Making Unit
EPU	Economic Planning Unit
EU	European Union
FDH	Free Disposable Hull
GDP	Gross Domestic Product
HDI	Human Development Indicator
HPI	Human Poverty Index
ICOMOS	International Council on Monuments and Sites
ICT	Information and Communication Technology
IRB	Inland Revenue Board
JAWHAR	Department of Zakat, Waqaf and Hajj
MABIMS	Religious Council for Brunei, Indonesia, Malaysia and Singapore
MIS	Management Information System
NAD	National Audit Department
NGO	Non-governmental organization
OLS	Ordinary Least Square
PSE	Public Sector Efficiency
PSP	Public Sector Performance
RM	Ringgit Malaysia
Rp	Rupiah Indonesia
SEM	Structural Equation Modelling
SFA	Stochastic Frontier Approach
SHD	Sustainable Human Development
SIRC	State Islamic Religious Council
SIRIM	Standard and Industrial Research Institute of Malaysia
SMS	Short-message-service
TFP	Total Factor Productivity
TQM	Total Quality Management
UNDP	United Nation Development Programme
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UNESCO	United Nations Economic, Social and Cultural Organization
VRS	Variable Returns to Scale

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

Today's organizations are facing challenges which require effective decision of management in order to achieve high levels of productivity and efficiency. *Zakat* institutions are no exception to this fact. They too face sizeable challenges that require effective and good governance to achieve efficiency. Hence, this study tries to explore the efficiency of *zakat* institutions in Malaysia and study the relationship between efficiency and governance of these institutions. This chapter begins with the motivations of the study, followed by the problem statement and further reveals the research questions and research objectives that arise in this research.

1.2 MOTIVATIONS OF THE STUDY

Zakat literally means to grow and to increase (Qardhawi, 2000). It is the 'portion of a man's wealth which is designated for the poor' (Sabiq, 1991). It is also defined as a compulsory levy imposed on Muslims so as to take surplus money or wealth from the comparatively well to do members of the Muslim society and distribute it to the destitute and the needy (Zaim, 1989). Muslims have the obligation to give a specific amount of their wealth (with certain conditions and requirements) to the specified beneficiaries. The eight beneficiaries are clearly specified in the *Qur'an* (Surah At-Taubah: 60), namely the poor; the needy; the administrator of *zakat*; those whose heart are to be inclined (including new Muslim converts who lack economic support); the

slaves; debtors (debts due to real needs); in the cause of *Allah (Fi sabilillah)*; and the wayfarers (*Ibnu sabil*) (Muhammad, 1980).

In Islam, all resources belong to Allah and wealth is held by human beings only in trust. It is part of the social system of Islam as the social goals of *zakat* indicate that Allah has given the poor a right in the wealth of the rich. Hence, *zakat* acts as a mechanism for the distribution of wealth which helps close the gap between the poor and the rich (Kahf, 1997). It may contribute positively to economic growth through several effects in macroeconomic variables (see Nik Hassan, 1991; Kahf, 1997; Awan, 1980; Sadeq, 2002). However, according to Awan (1980) and Nik Hassan (1991), it can only be achieved if a comprehensive Islamic system is applied by a country.

Zakat institutions are the institutions responsible for managing the collection and distribution of *zakat* funds. In the Quran, the main categories of *zakat* expenditure are clearly described. The Quran also mentions the appointment of officials to collect and distribute *zakat* which should be in the form of either a department of the state or at least a public fund managed entirely by a public body (Muhammad Ali, 2011). Hence, the state has the responsibility of collecting and distributing *zakat* in a well-organized system as prescribed by Islam. In addition, *zakat* involves the Muslim society as a whole. Hence, certain ulama' like Imam Syafie suggests that *zakat* must be paid to the authority (Buang, 2000). Furthermore, since *zakat* nowadays has become an important part in an Islamic society, the opinion of Imam Syafie becomes more practical.

The main objective of *zakat* is the achievement of socio-economic justice (Kahf, 1989). *Zakat* can provide an alternative to the shortcomings of the secular economic system as the main focus of *zakat* is to alleviate poverty through the transfer

of wealth from the rich to the poor. The Islamic system of *zakat* places human welfare and well being of individual human beings as important objectives in achieving socio-economic justice. Proper distribution of *zakat* funds will ensure that the poor in a community may enjoy a decent standard of living or at least be able to overcome or reduce poverty. It is the responsibility and amanah of the institution of *zakat* to achieve the goals and objectives of *zakat*.

In Malaysia, such *zakat* institutions are the State Islamic Religious Councils (SIRCs). These institutions are expected to play a key role in promoting the socio-economic objectives of *zakat* in Malaysia. Thus, it is of prime importance that these institutions are managed efficiently and effectively. Being public service organizations which are accountable to the stakeholders and Muslim public at large, these *zakat* institutions have been subjected to intense public scrutiny and criticism. cursory examination indicates that many parties are questioning the efficiency and effectiveness of these institutions in managing *zakat* affairs in their respective states. Given this continuously arising public concern, it is of prime importance that the efficiency of these *zakat* institutions is examined closely.

Efficiency deals with both inputs and outputs. Specifically, it measures how productive inputs are being turned into outputs. Besides efficiency, there are two other E's that should be measured in a public sector organization, namely Economy and Effectiveness. Economy represents the relationship between resources expended or budgeted for an activity and what is received for. Economy concerns only input, where it is the minimization of input for a given level of output. Thus, economy measures are usually expressed in the form of cost, budget and number of staff in an organization.

Meanwhile, effectiveness focuses mainly on outputs; it refers to goods and services produced as a direct result of management activities. An additional measure of performance is outcomes which refers to the consequences of the output produced (Schacter, 1999 in Abdul Rahman, 2007). In the present study, the efficiency of *zakat* institutions will be evaluated as one of the performance measurement systems.

In the case of *zakat* institutions, the efficiency of *zakat* institutions is important since the institutions play extremely crucial role in determining major economic variables. Besides, as institutions that manage financial resources, there are intense public awareness and scrutiny on the management of *zakat* institutions in Malaysia especially in terms of the lack of accountability of the management (Ahmad, 2006; Wahid et al., 2008; Wahid et al., 2009). Public concern on the efficiency of *zakat* institutions arises as issues of misuses of *zakat* funds and frauds by *amil* have continued to be unresolved issues. For example, a mainstream major Malay newspaper, Utusan Malaysia (2001) reported that the institution of *zakat* in Malaysia is still inefficient as there are still a growing number of the poor and needy in Malaysia. It was reported that this situation is due to the inefficient management of *zakat* distribution since total zakat collection is increasing every year. BERNAMA¹ (2008) revealed cases of misappropriation of *zakat* fund in Selangor and an *amil* in Johor who had stolen RM18 thousands of zakat fund in 2011. Efficiency is crucial to ensure proper zakat administration. However, efficiency may not be the only contributing factor for the increased number of poor people. Nevertheless, an investigation on the efficiency of the institution is important to evaluate the extent of *zakat* institutions' efficiency in Malaysia.

¹ The Malaysian National News Agency.

In investigating the efficiency of *zakat* institution, it must be recognized that the governance aspect of the institution is equally important in driving efficiency. Governance is defined as the process of decision-making and the process by which decisions are implemented. A good governance institution is an institution that is directive, accountable, transparent and fair. These principles are important to ensure the achievement of goals and objectives of the institution. For many authors, good governance is the key variable in driving an institution towards the achievement of its objectives. Kaslam (2011) for instance, mentioned that good governance requires that the management must govern the institution with full integrity and the management is accountable to the stakeholders of the institution in achieving its objectives. They must be transparent and disclose general information to the public and stakeholders. Hence, a study on the governance of *zakat* institution is important towards the achievement of the respective goals and objectives.

Therefore, it is important to investigate the extent of efficiency and good governance of *zakat* institutions in Malaysia and to find out what are the other factors that contribute to the efficiency of the institutions. In addition, as public institutions that manage the resources and funds of the Muslim public, *zakat* institutions need to fulfill the accountability role through efficiency and good governance of the organization, since it is the Muslim public rights as the stakeholders of the organization to demand for better accountability of the organization. Hence, this study is hoped to provide important empirical evidence on the governance mechanism as well as the efficiency of *zakat* institutions in Malaysia.

Furthermore, due to the lack of empirical research in this area, this could be the first study on the efficiency as well as on the governance of *zakat* institutions. Closer examination of the role of various governance characteristics and mechanisms

is important as *zakat* institutions control significant resources. This study is hoped to contribute to the dearth of empirical literature on *zakat* institutions, specifically on the efficiency of the institutions in managing *zakat* funds. Moreover, the results of the study will be useful as guidance to policy makers in improving the institutions' governance system in order to improve their efficiency.

1.3 PROBLEM STATEMENT

In most Muslim countries, *zakat* is managed as a peripheral system. It is seen to be as less important compared to tax, since the taxation system becomes an integral part of the fiscal system, whereas *zakat* just becomes a voluntary system (Abu Bakar & Abdul Rahman, 2007). Furthermore, the business world today is focusing mainly on wealth creation (eg. banks etc.), but places little emphasis on wealth distribution. On the other hand, Islam encourages an individual to work and earn a legitimate income to sustain him and his family, but Allah has reminded the Muslim to achieve a balance between worldly life and the hereafter. Hence, the distribution of wealth should go hand in hand with the creation of wealth. In other words, emphasis should not be given only to wealth creation but also to its distribution to ensure an equitable Islamic financial system.

In Malaysia, *zakat* institutions are administered under the respective states jurisdiction as part of the administration of the State Islamic Religious Council (SIRC). Thus, the law on *zakat* is governed by each state's enactment, except for the states of Kedah, Sabah and Sarawak where they have their own *zakat* law (Bakar, 1998). Even though there have been establishments of the Department of Islamic Development (JAKIM) and the Department of *Zakat, Waqaf and Hajj* (JAWHAR), their roles have been mainly to coordinate and promote the institutions in Malaysia.

Hence, the development of a proper measurement system is crucially important in ensuring that the institutions are driving towards the goals and objectives desired. Abdul Rahman (2007) for instance, suggests the development of a proper performance measurement system of *zakat* to effectively integrate *zakat* into mainstream Islamic financial system in Malaysia. Abdul Rahman (2007) urged that Malaysian Constitution should take pro-active steps in developing an objective and fair measurement of *zakat* on business wealth in Malaysia through the introduction of rebate of tax liability to companies that pay *zakat* on business wealth. A standard *zakat* accounting practices are needed to satisfy the need of interested users of *zakat* financial information. The implementations of the proposed pre-requisites are important in effectively integrating *zakat* into mainstream Islamic financial system in Malaysia.

Thus, the government (especially JAWHAR and the SIRC's) plays an important role in assimilating this institution into the mainstream financial system, similar to what was done to other financial institutions. The governance of the institution is important in ensuring an efficient collection and distribution of funds. Abdul Rahman (2003) for instance, suggested that the federal government should institute good financial management practices and reform *zakat* distribution practices in order to promote good governance of *zakat* institution. He also proposed the introduction of two *zakat* governance measures ie. the promulgation of accounting standards and structural and policy reform towards a more effective *zakat* distribution. Organizations such as the SIRC's need a comprehensive governance structure and a good code of financial management.

Furthermore, being public organizations, *zakat* institutions have been subjected to intense public scrutiny and criticism especially on the efficiency and effectiveness

of the institution in managing *zakat* affairs. *Zakat* institutions in Malaysia have been said as being inefficient and operating under its real potential outcome (Sadeq, 1995; Abdul Wahab, 1995). Recent studies also revealed that there were criticisms on the efficiency of *zakat* institutions, especially in terms of the funds' distribution (Ahmad et al., 2006; Muhammad, 2008; Wahid et al.; 2008; Wahid et al., 2009). Ahmad et al. (2006) found that 57.1 percent of the respondents in their study were dissatisfied with the distribution of *zakat* funds in Malaysia and this significantly influence *zakat* payments to formal institutions. The same results were shown by Muhammad (2008) who examined the perception of academicians in Selangor and Kelantan on the effectiveness of *zakat* administration in the distribution and collection of *zakat* funds and the accessibility and sufficiency of information provided to the public towards their attitude of paying *zakat* directly to the recipients. The study suggests that a good perception on *zakat* distribution is significantly and positively associated with payment of *zakat* through the SIRC's. Wahid et al. (2008) and Wahid et al. (2009) revealed that the two main factors of dissatisfaction towards *zakat* institutions are the ineffectiveness of *zakat* distribution and the insufficiency of *zakat* distribution information. The criticism towards the administration of *zakat* institutions shows that there is a lack of accountability of the councils which may affect the efficiency of the institutions in attaining its social objectives.

Furthermore, there have been only a few empirical studies on *zakat* institutions. Past empirical studies on *zakat* have focused mainly on the collection and distribution of *zakat*. Hence, the lack of research that explores the efficiency of these institutions and the public scrutiny, together with poor governance and lack of accountability of the institutions are the major motivations of this research. Thus, this

study attempts to examine to what extent good governance contributes to the efficiency of *zakat* institutions in Malaysia.

1.4 RESEARCH QUESTIONS

Based on the literature provided, the question of whether *zakat* institutions in Malaysia are efficiently or effectively managed is still undetermined. The criticism on the efficiency of the institutions in managing *zakat* funds could be highly associated with the institutions' governance, especially in terms of the transparency and accountability of the institutions.

In line with the problem statement, the research questions of this study include:

- (1) What are the development and contemporary issues of *zakat* institutions in Malaysia?
- (2) What is the level of efficiency of *zakat* institutions in Malaysia?
- (3) To what extent are the *zakat* institutions in Malaysia technically efficient or scale efficient?
- (4) To what extent does governance structure influence the level of efficiency of *zakat* institutions in Malaysia?
- (5) What are the factors influencing the efficiency of *zakat* institutions in Malaysia?

1.5 RESEARCH OBJECTIVES

The aim of this study is to measure the efficiency of *zakat* institutions in Malaysia. It also aims to undertake an in-depth investigation on the role of governance and other determinants towards the efficiency of *zakat* institutions in Malaysia. Ultimately, this