

# Brief Introduction to Islamic Economics

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# Outline

- Introduction
- Consumer Behavior from Islamic Perspective
- Producer Behavior from Islamic Perspective
- Financial Intermediation Principles
- Redistribution Mechanisms
- Economic Growth in Islamic Economy

# Introduction

- What is the basic Economic Premise?
- “Resources are scarce in comparison to wants”
- Is it a Positive or a Normative Statement?
- Let us see!

# Introduction

- Budget on some films and video games is more than development spending in some countries.
- Expenditure on reducing fat is more than expenditure on reducing hunger.
- Food crops are burned at some places for price stability while half of planet starves.
- 85 wealthiest individuals in the world have a combined wealth equal to that of the bottom 50% of the world's population.
- Some individual persons own more wealth than entire countries GDP.

# Introduction

- There are approximately 1 billion poor in the world.
- If it takes Rs 3,000 to feed a poor person for a month, then Rs 3,000 billion can feed all of world's poor for one month.
- If exchange rate is Rs 105 per USD, then with 3.7 trillion USD combined net worth of 300 wealthiest people at December 31, 2013, they can feed all of world's poor for 10 years at least. **(Source: Bloomberg)**
- 300 people only can feed all of world's poor for 10 years!

# Introduction

- Income earned by the top 10 showbiz personalities together are more than entire combined production value of 7 countries of the world.
- 10 persons selling entertainment earn more than what all people together in 7 countries earn!
- Top in that list earns more than GDP of at least 4 countries of the world.

# Introduction

- A new premise “Inequitable distribution of resources is the problem.”
- Another problem is unbridled pursuit of self-interest to fulfill as much of the wants as is possible.

Available Resources	Needs
	Wants
Unavailable Resources	



# Introduction

- Nobel Laureate Amartya Sen empirically studied famines in Bengal.
- His conclusion was that famines were caused not because of lack of resources, but because of ill-distribution of resources in the affected regions.
- Inequality of income has risen even in developed countries over a long period of time.

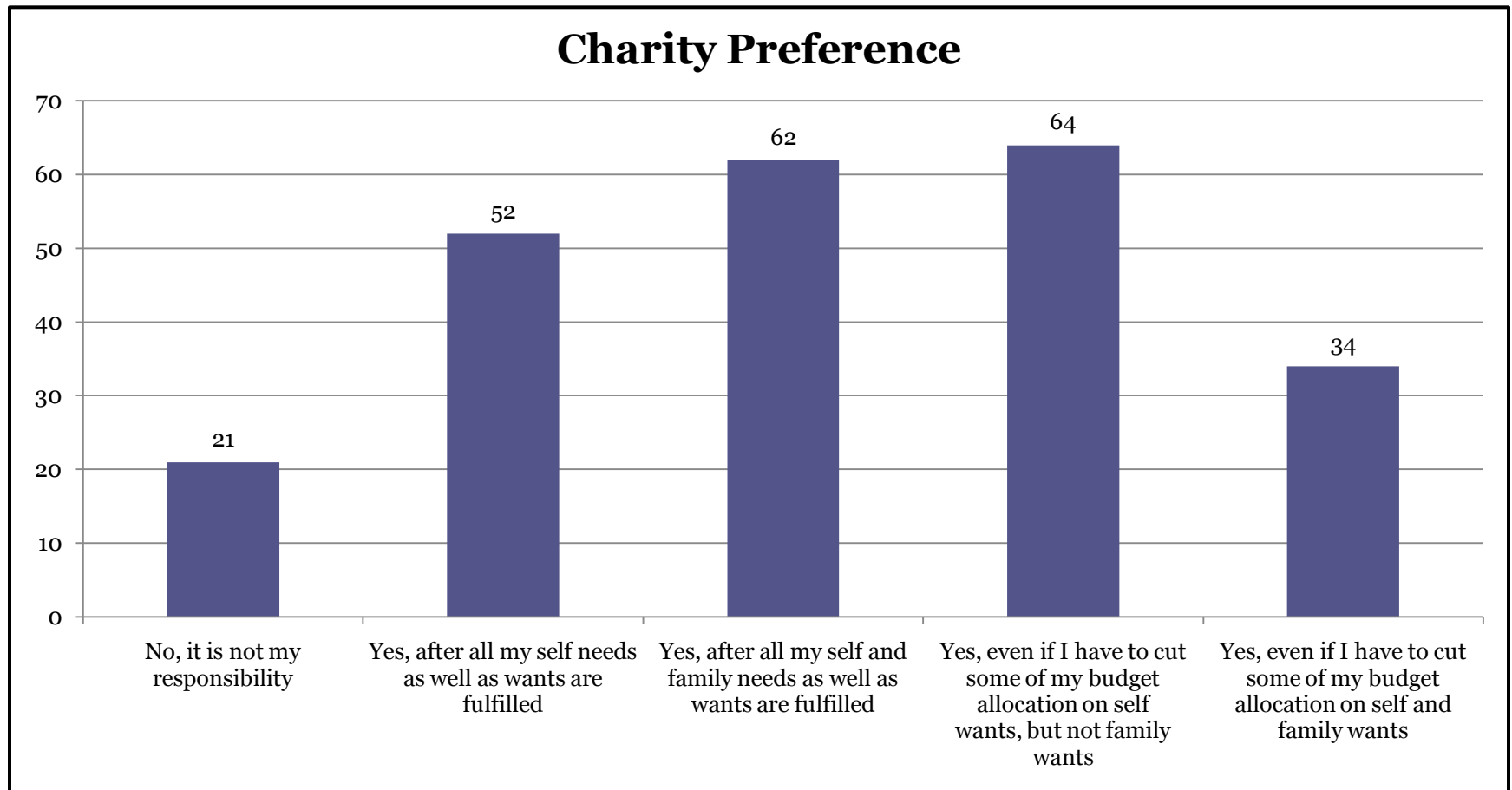
# Scarcity is Non-Trivial

- Consider 50 students are sitting in a class room.
- Then, one student starts to distribute handouts.
- Behavior of students will be significantly different when they think that the handouts are not sufficient for the class size as compared to when they think that the handouts are sufficient in number so that every student could have one.
- If they think that resources are scarce and handouts are distributed from first rows to the last rows, then those at back (future generations) may not get much resources (handouts) from those in front (present generation).

## Do People Distinguish Between Needs & Wants?

- **Question: If you come across a community welfare program you can trust and find it credible with appropriate checks and balances, will you be willing to contribute your monthly budget on it?**
- **Survey response from 250 respondents is as follows:**

# Do People Distinguish Between Needs & Wants?



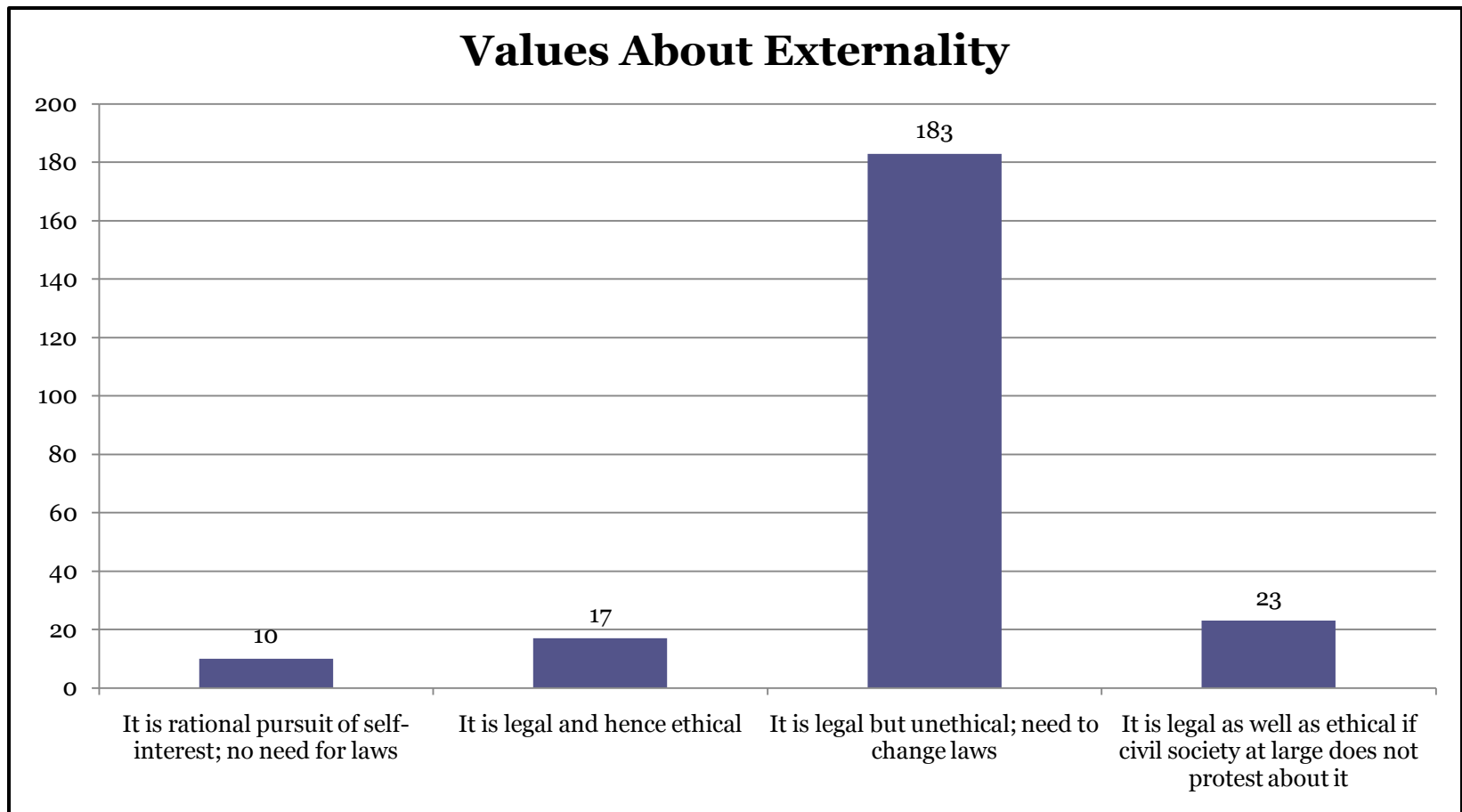
## Do People Distinguish Between Needs & Wants?

- Less than 10% people in the sample feel that they are not responsible for helping people with lesser resources.
- As much as 90% people in the sample are willing to spend in charity if they come across a credible charitable project.
- This shows that problem may not be with consumer preferences or axioms like monotonicity when it comes to finding ways of community welfare, the problem may very well be with institutions and their quality that carry out the community welfare programs.
- Almost 50% people in the sample are willing to spend in charity even if they have to cut on their self and/or family wants.
- It also shows that people distinguish between needs and wants when it comes to consumer choices.

# Do People Regard Legal as Ethical?

- **Question: If a producer creates a negative externality (pollutes air, spills oil in river etc.) in society from its production process and is able to satisfy law in the jurisdiction where it operates, how will you analyze it?**
- **Survey response from 250 respondents is as follows:**

# Do People Regard Legal as Ethical?



# Do People Regard Legal as Ethical?

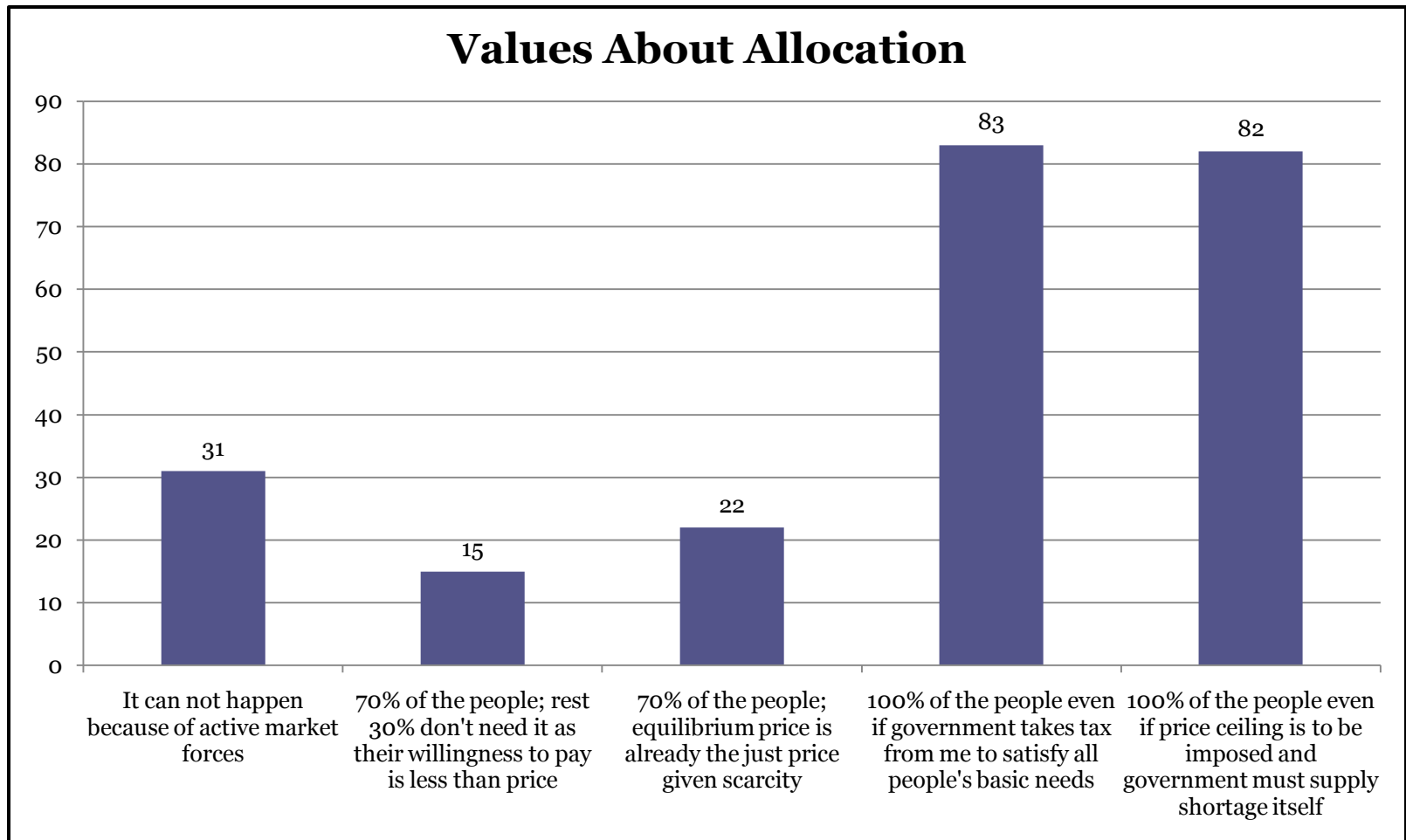
- All things legal are not necessarily ethical in the perceptions and views of the 250 respondents.
- Almost 80% of the people think that creating negative externality is unethical.
- This also indicates that the values of the respondents are not just restricted to self-centric framework.
- Even when an externality creates social disharmony, people feel negative about it even if they are not directly affected by it.



## Allocation of Resources? For Whom?

- **If in a country, each of 200 million people require 250 grams of wheat daily, but only 70% of them are able to afford it at equilibrium market prices, for whom should the wheat shall be produced?**
- **Survey response from 250 respondents is as follows:**

# Allocation of Resources? For Whom?



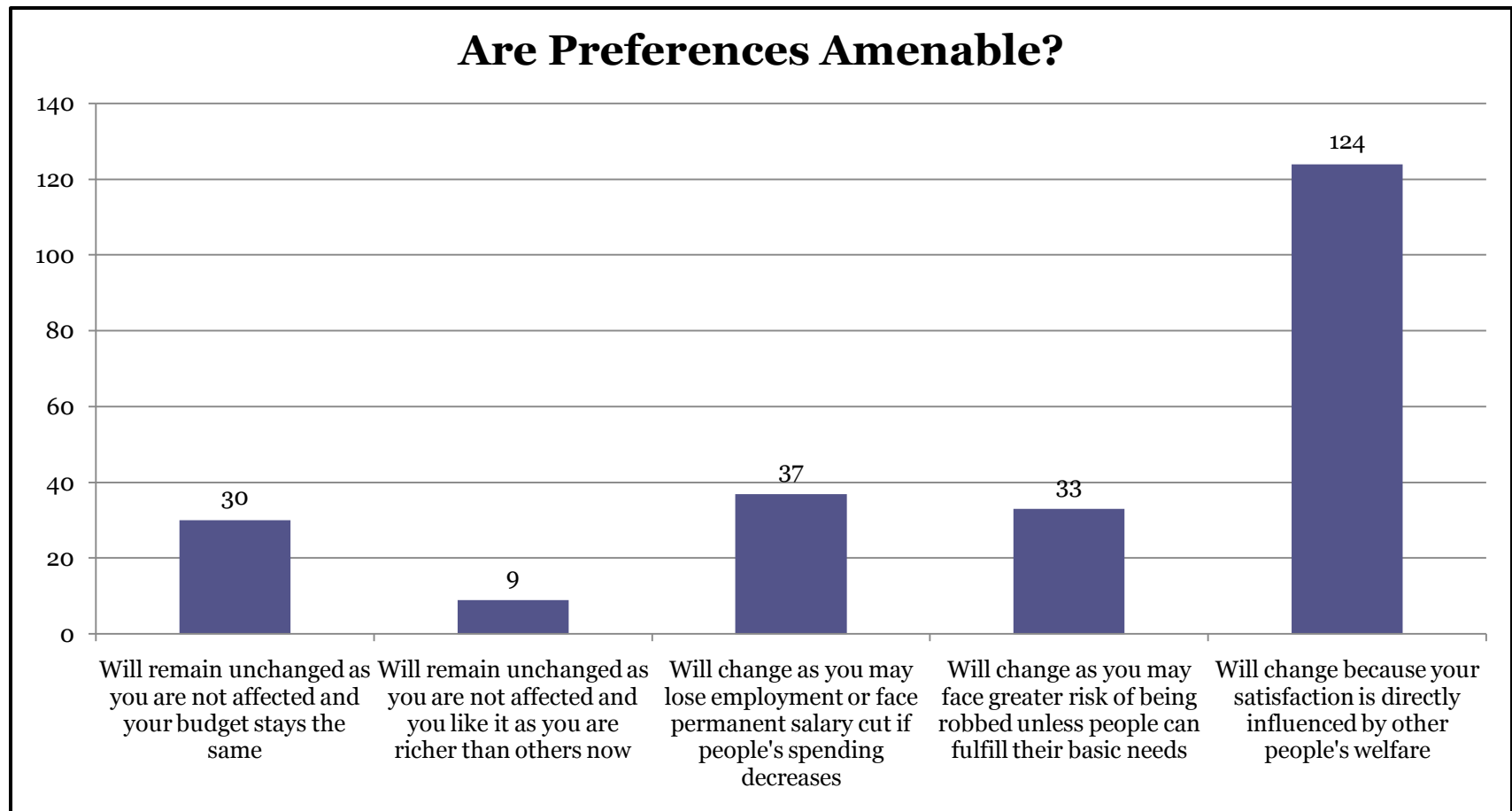
# Allocation of Resources? For Whom?

- 70% of the people in the sample think that provision of basic necessities is a bigger value than maintaining a certain kind of private property rights system.
- Not only people are sensitive about egalitarian objectives, rather they are willing to sacrifice their self-purchasing power by willing to pay taxes.
- Only 12% people think that such a situation as described in the question is not possible in a market economy.

# Are Preferences Amenable?

- **Question: If your budget remains unchanged and a disaster affects people near you and decreases their budget, your preferences:**
- **Survey response from 250 respondents is as follows:**

# Are Preferences Amenable?



# Are Preferences Amenable?

- More than 85% of the respondents state that their preferences will change given an exogenous event which even though does not affect their income/budget.
- This also shows that people's choices in the sample are responsive of interpersonal utility functions.
- Hence, the usual procedure of computing consumer welfare from individual utility functions that disregard interpersonal relationships is a questionable approach (Gowdy & Mayumi, 2001).

## Consumer Behavior from Islamic Perspective

- Humans are much more than utility maximizing species.
- They differentiate right from wrong and need reinforcement to adopt virtues influenced by an inner urge other than just material interests.

## Consumer Behavior from Islamic Perspective

- Gregory Mankiw writes ‘People react to incentives, rest is commentary’ in his principles level book.
- That commentary whether explained in a two-dimensional graph, calculus or real analysis, does not add any additional insight than ‘people react to incentives, are selfish, are greedy and the best one can do is to let them be and just believe that’.



## Consumer Behavior from Islamic Perspective

- This fundamental principle of economics is a trivial statement about humans where they are relegated to the state of mere animals, slaves of their base desires and incapacitated by their conscience and failed by even call of teachers, preachers, prophets and scriptures to overcome the base instincts.
- Isn't that mockery of all that we know as human?

# Consumer Behavior from Islamic Perspective

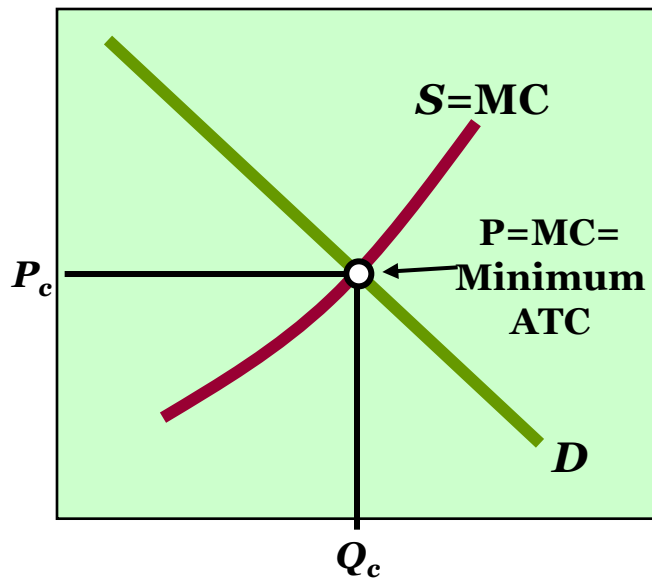
- Balanced Consumption.
- Avoiding Unnecessary Indebtedness.
- Avoiding unethical consumption.
- Treating the endowment/budget as trust.
- Encouragement for Infaq.
- Moral upliftment to avoid:
  - Takabbur (Pride)
  - Hasad (Jealousy)
  - Israf (Lavish consumption)

## Producer Behavior from Islamic Perspective

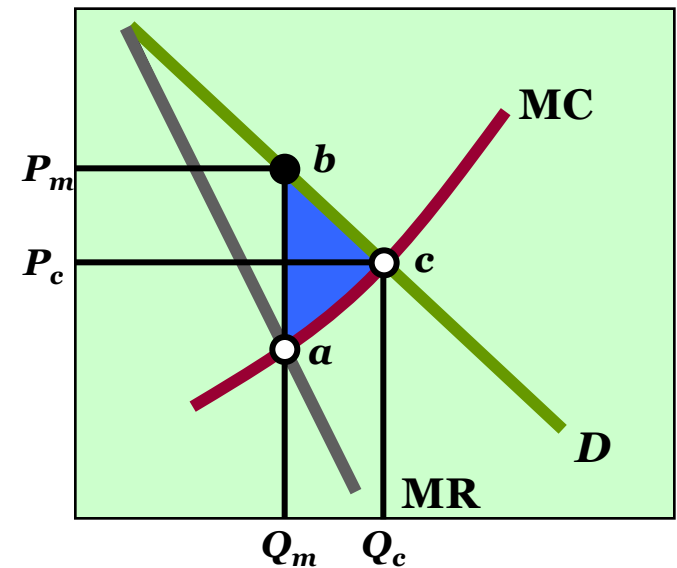
- Moral upliftment to avoid:
  - Price manipulation.
  - Hoarding.
  - Fraud and misrepresentation.
  - Bear responsibility for social costs (externalities).
  - Responsible for deadweight loss created by self action in imperfect market structures.

# Economic Effects

**Purely  
Competitive  
Market**



**Pure  
Monopoly**



We know that pure competition is efficient while monopoly is inefficient. But, monopolist selling a necessity in Islamic economy is expected to produce where  $P=MC$

## Producer Behavior from Islamic Perspective

- Consumer preferences will be served within ethical bounds.
- Avoid unnecessary moral persuasion and consumerism.
- Resources and their benefits are a trust from Allah and a gift. There is secondary right of poor people in it.

# Financial Intermediation Principles

- Risk based enterprise.
- No fixed return on capital in the form of interest.
- Equity financing preferable over debt financing.
- In debt based mode of finance, it shall be real asset backed.

# Problems with Interest Based Finance

- It ignores the negative externality imposed through inflation on people. Interest paid is added in cost and through transfer pricing, it is paid by consumers eventually.
- It discourages investment in socially optimal profitable projects, but which are not favored because of relative costing comparison from prevalent real interest rate.

# Problems with Interest Based Finance

- It compels firms to engage in aggressive advertising and promoting consumerism to meet interest cost. Selling small number of units will not allow benefit from leveraging and meeting interest cost. Hence, they have no choice than to promote as much sales as possible.
- If sales do not increase, it may lead to business cycle fluctuations with unplanned increase in inventories.
- With increased pressure to service debt, the environmental degradation and human resource exploitation may become common.



# Problems with Interest Based Finance

- It results in skewed distribution of income and wealth with guaranteed return to capitalists and uncertain return to real sector entrepreneurs who are burdened to provide incessant increase in capital lent by the financial capitalists.
- It supports only the wealthy entrepreneurs who are able to afford interest payments right from the start from their entrepreneurial pursuits & who already own capital that can be used as collateral. This will affect the kinds of entrepreneurial investments they make and hence allocation of resources.

# Problems with Interest Based Finance

- With barriers to entry due to restricted availability of funds for investment in real sector, the real sector could result in increased market concentration in large scale businesses.
- It may result in other negative externalities, e.g. increased income inequality, poverty and below full employment use of real scarce resources resulting by artificially making capital scarce.
- Increased printing of fiat money by borrowing on interest will jeopardize the welfare of future generations. With no afterlife accountability, no policy maker or institution can incorporate infinite horizon and accountability to future generations. This will create the problem of moral hazard.

# Great Financial Crisis

- “US credit market debt was 168% of GDP in 1981 and over 350% in 2007. Financial assets were less than five times larger than US GDP in 1980, but over ten times as large in 2007. The notional value of all derivative contracts rose from about three times global GDP in 1999 to over 11 times global GDP in 2007. The notional value of credit default swap derivatives rose from about \$6 trillion in December 2004 to \$62 trillion three years later. In the US, the share of total corporate profits generated in the financial sector grew from 10% in the early 1980s to 40% in 2006.”
- (Source: The Economist, “What Went Wrong”, March 19, 2008).

# Great Financial Crisis

- These increased financial sector incomes are transaction cost to the real sector and the real sector only lost credit lines despite having to bear high transaction costs before and during the crisis.

# Economic Merits of Islamic Modes of Financing

- From the risk and profitability perspective, Islamic modes of financing keep the Islamic financial system liquid and less prone to risk due to asset backing.
- Islamic financial intermediary enables credit availability to ensure that productive transactions are executed and also, it reduces the transaction and monitoring costs which result in more productive transactions happening in the economy.

# Economic Merits of Islamic Modes of Financing

- Often, the investors with bank (the deposit holders) are risk averse and want consistent returns. But, small savers do not have enough funds to finance big volume projects directly.
- But, using investors' pool of funds to provide financing, the investors are able to share in benefit of such economic activities.

## Boosting Investment in Islamic Economy

- Wealth Zakat on cash and capital motivates the people to invest their money in productive enterprise.
- With prohibition of interest, the investible resources can only go in business either with the start of one's own business or equity participation in other businesses through stocks etc.

## Boosting Investment in Islamic Economy

- A consistent and credible low tax rate policy with broader Zakat base ensures minimum distortions, boosts aggregate demand and encourages investment by decreasing costs of doing business.
- This could also simultaneously solve microeconomic problems of imperfection in markets by increasing competition and helping to reduce market power.



# Redistribution Mechanisms in Islamic Economy

- **Prohibition of Interest**
- Islam encourages equity financing in which the loss/profit is shared & payoffs are linked with productive sector of the economy.
- Consequently, markets will not have to produce speculative surplus output just to service exorbitant amount of debt and that could stabilize business cycles.

# Redistribution Mechanisms in Islamic Economy

- **Family System & Inheritance Distribution**
- Family system of Islam brings social capital into existence.
- It brings a very lasting and durable social safety net.
- Inheritance laws ensure that the wealth of the deceased is distributed widely among the members of the family of the deceased and this permanently and systematically ensures doing away with the concentration of wealth in every generation.

# Redistribution Mechanisms in Islamic Economy

- **Zakat & Infaaq**
- With Wealth Zakat, redistribution objective is directly achieved.
- It ensures appropriate transfer of wealth and transfer of asset ownership to the needy.
- If an economy is in disequilibrium and policies fail to immediately recover and boost incomes, wealth Zakat enables the distributive allocation that works independently of the business cycles and help stabilize the extremes of business cycles.

# Wealth Concentration & Zakat

- Suppose in an economy, there are two individuals, A and B.
- Let us assume that both earn fixed income from labor.
- Both have same level of wealth, i.e. Rs 1,000,000 initially.
- In an interest based system, there is 10% rate of interest offered on deposit, net of taxes.
- In an Islamic economy, there is no such possibility of earning fixed return on accumulated wealth.

# Wealth Concentration & Zakat

A				B		
Period	Wealth	Interest		Period	Wealth	Zakat
0	1,000,000			0	1,000,000	
1	1,100,000	100,000		1	975,000	25,000
2	1,210,000	110,000		2	950,625	24,375
3	1,331,000	121,000		3	926,859	23,766
4	1,464,100	133,100		4	903,688	23,171
5	1,610,510	146,410		5	881,096	22,592
6	1,771,561	161,051		6	859,068	22,027
7	1,948,717	177,156		7	837,592	21,477
8	2,143,589	194,872		8	816,652	20,940
9	2,357,948	214,359		9	796,236	20,416
10	2,593,742	235,795		10	776,330	19,906
11	2,853,117	259,374		11	756,921	19,408
12	3,138,428	285,312		12	737,998	18,923
13	3,452,271	313,843		13	719,548	18,450
14	3,797,498	345,227		14	701,560	17,989
15	4,177,248	379,750		15	684,021	17,539
16	4,594,973	417,725		16	666,920	17,101
17	5,054,470	459,497		17	650,247	16,673
18	5,559,917	505,447		18	633,991	16,256
19	6,115,909	555,992		19	618,141	15,850
20	6,727,500	611,591		20	602,688	15,454

# Wealth Concentration & Zakat

- After 20 years, the last row shows the wealth disparity between two individuals.
- Wealth multiple initially is 1:1 whereas, wealth multiple after 20 years is 11.16 and it is going to increase exponentially with compounding.

# Thank You

For Questions & Feedback

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