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### **Prospects for Methodological Integration in Islamic Economics**

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# Presentation Outline

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- ▶ Descriptive Axioms about Human Behaviour in Islamic Texts
- ▶ Prescriptive Teachings Governing Economic Behaviour in Islamic Worldview
- ▶ Distinction and Compatibility Between Islamic and Mainstream Framework
- ▶ Methodological Framework For Studying Economic Behaviour
- ▶ Conclusion

# Descriptive Axioms about Human Behaviour in Islamic Texts

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- ▶ *Qur'an* mentions that humans are generally:
    - ▶ **Hasty** (Al-Isrā 17: 11).
    - ▶ **Miserly** (Al-Isrā 17: 100).
    - ▶ **Impatient** (Al-Ma'arij 70: 19).
    - ▶ **Have love of wealth** (Al-ādiyat 100: 8).
  
  - ▶ Thus, humans have:
    - ▶ Impatience.
    - ▶ Positive time preference.
    - ▶ Tendency to economize on expenditure.
    - ▶ Desire for material resources.
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# Descriptive Axioms about Human Behaviour in Islamic Texts



- ▶ Islamic texts mention **consumption externalities** and the human desire to consume **positional goods** and indulging in **conspicuous consumption** (Al-Takāthur 102: 1-2).
- ▶ According to Islamic texts, human instinct prefers goods which serve **survival needs** as well as other wants which serve **aesthetic desires** (Al-‘Imrān 3: 14).
- ▶ The story of Jews asking Moses (pbuh) for a variety of food (Al-Baqarah 2: 61) also hints at the desire for variety in consumption bundles. **Basis of DMU.**
- ▶ There is a tendency for **non-satiated preferences**. Prophet Muhammad (pbuh) said: **“The heart of an old man remains young with regards to two things: Love of life and wealth”** (Al-Muslim, Book of Zakāt, Vol 3, Hadith No. 2410).



# Islamic Worldview on Economic Distribution



- ▶ According to the Islamic teachings, this **worldly life** is a **trial** for humans in which they are being **tested** for their **thankfulness** and **obedience** to Allah (Al-Mulk 67: 2).
- ▶ In this test nature of life, Allah has given **unequal endowments** to humans **so that they employ each other** (Al-Isrā 17: 30; Al-Ankabut 29: 62; As-Saba 34: 39; Ash-Shura 42: 12 and Az-Zukhruf 43: 32).
- ▶ **The divine will on endowment inequality is also a means to test their thankfulness and patience.**



# Teachings Governing Economic Behaviour in Islamic Worldview

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## Moral Filtering on Seeking Endowments

- ▶ The Islamic teachings encourage striving for *Halāl* means of earning (Al-Mulk 67: 15) as long as impermissible means and ways of earning are avoided, such as:
  - ▶ **Interest** (Al-Baqarah 2: 276),
  - ▶ **Bribery** (Al-Baqarah 2: 188),
  - ▶ **Fraud** (Al-Mutaffifeen 83: 1-4),
  - ▶ **Gambling** (Al-Maidā 5: 90),
  - ▶ **Theft** (Al-Maidā 5: 38),
  - ▶ **Business of intoxicants** (Al-Maidā 5: 90)
  - ▶ **Prostitution** (Al-Nur 24: 19).



# Teachings Governing Economic Behaviour in Islamic Worldview



## Islamic Teachings Governing Conduct of Producer

- ▶ Islam allows **trade**, but cautions against **unfairness, exploitation** and **deceit** (Al-Baqarah: 188; Al-Nisa: 29).
- ▶ Islamic teachings related to commerce also strongly recommend **fairness** in trade dealings (Al-Bani-Israel: 35; Al-Mutaffifin: 1-4).
- ▶ Islam emphasizes on **fulfilling contractual obligations** in mutual exchange (Al-Maida: 1).
- ▶ Islam discourages **accumulation for the purpose of hoarding** (Al-Tauba: 34).
- ▶ Islamic teachings denounce **taking oaths for deceiving** (Al-Nahl: 92).



# Teachings Governing Economic Behaviour in Islamic Worldview



## Islamic Teachings Governing Conduct of Producer

- ▶ Islam encourages **documenting the terms of the agreement** to **mitigate the risk of moral hazard** (Al-Baqarah: 282).
- ▶ Islamic principles of trade **allow credit transactions** and **debts** but **condemn defaulting on loans** (Sunan Ibn-e-Maja, Vol 3, Chapters on Charity, *Hadith* Number 2410).
- ▶ In selling goods, it is highly recommended that **deceit is avoided in making and selling of products**. (Sunan Ibn-e-Maja, Vol 3, Chapter on Business Transactions, *Hadith* Number 2246).
- ▶ **Deceit in contracts to get an unfair advantage is strongly condemned in Islam**. (Al-Bukhari, Vol 3, Book of Watering, *Hadith* Number 2356).





# Teachings Governing Economic Behaviour in Islamic Worldview

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## Moral Filtering on Consumption Set

- ▶ *Qur'an* **allows eating lawful and good things on earth** (Al-Baqarah 2: 168; Al-Nahl 16: 114; Al-Mu'minun 23: 51).
- ▶ Impermissible goods are axiomatically excluded from the consumption bundle.
- ▶ For instance, Islam forbids :
  - ▶ **Intoxicants** (Al-Baqarah 2: 219),
  - ▶ **Meat of dead animals, blood and flesh of swine** (Al-Baqarah 2: 173).
  - ▶ In financial services, Islam forbids **interest** (Al-Baqarah 2: 276) and **gambling** (Al-Maidā 5: 90).
  - ▶ On some occasions, even the lawful goods become impermissible, such as during the time of fasting (Al-Baqarah 2: 183).



# Teachings Governing Economic Behaviour in Islamic Worldview



## Moderation in Consumption

- ▶ Qur'an says: **“And let not your hand be tied (like a miser) to your neck, nor stretch it forth to its utmost reach (like a spendthrift), so that you become blameworthy and in severe poverty”** (Al-Isrā 17: 29).
- ▶ In another verse, Qur'an says: **“And those, who, when they spend, are neither extravagant nor niggardly, but hold a medium (way) between those (extremes)”** (Al-Furqān 25: 67).
- ▶ In a *Hadith*, Prophet Muhammad (pbuh) said: **“Spend according to your means; and do not hoard, for Allah will withhold from you”** (Al-Muslim, Book of Zakah, Vol 3, *Hadith* No. 2378).
- ▶ Islam expects Muslims to avoid being spendthrift and extravagant. Allah in Qur'an says: **“... Waste not by extravagance. Verily, He likes not those who waste”** (Al-Anam 6: 141). In another verse, Allah in Qur'an says: **“...Spend not wastefully (your wealth) in the manner of a spendthrift”** (Al-Isrā 17: 26).

# Teachings Governing Economic Behaviour in Islamic Worldview



## Avoiding Envy, Pride, Egoism and Boastfulness

- ▶ Islam wants Muslims to **observe humbleness** and **shun pride** (Al-Isrā 17: 37; Luqman 31: 18).
- ▶ Qur'an says that **Allah does not like self-deluded and boasters** (Al-Hadid 57: 23).
- ▶ Islam also does not approve envious behaviour. Qur'an says: **"The desire for piling up of worldly things diverts you until you reach the graves"** (Al-Takāthur 102: 1-2). Instead, Qur'an prescribes: **"... Do not covet the bounties which God has bestowed more abundantly on some of you than others..."** (Al-Nisā 4: 32).
- ▶ Prophet Muhammad (pbuh) said: **"Envy consumes good deeds just as fire consumes wood, and charity extinguishes bad deeds just as water extinguishes fire"** (Sunan Ibn-e-Maja, Chapters on Asceticism, Vol 5, Hadith No. 4210).

# Teachings Governing Economic Behaviour in Islamic Worldview

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## Avoiding Envy, Pride, Egoism and Boastfulness

- ▶ Prophet Muhammad (pbuh) advised: *“Look at the one who is at a lower level than you, and do not look at the one who is above you, for that may keep you from scorning the blessings of Allah”* (Al-Muslim, Book of Asceticism, Vol 7, Hadith No. 7430).
  - ▶ *Qur'an* educates Muslims that wealth will not last forever (Al-Humazah: 1-3). Wealth and children are only a trial (Al-Taghābun 64: 15).
  - ▶ In one *Hadith*, Prophet Muhammad (pbuh) said: *“Richness is not in having many possessions, but richness is to be content with oneself”* (Jamai-at-Tirmidhi, Chapters on Zuhd, Vol 4, Hadith No. 2373).
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# Teachings Governing Economic Behaviour in Islamic Worldview



## Encouragement Towards Pure Altruism

- ▶ Islam does not recognize **impure altruism** to satisfy **ego** and to achieve **fame** and recognition (Al-Baqarah 2: 264; Al-Ma'un 107: 6).
- ▶ Prophet Muhammad (pbuh) **advised anonymity** and **secrecy** in **charitable giving** such that the right hand does not know what the left hand is giving (Al-Muslim, Book of *Zakāt*, Vol 3, *Hadith* No. 2380).
- ▶ Allah says of the ideal believers in *Qur'an*: **“And they give food, in spite of their love for it to Miskin (poor), the orphan, and the captive. (Saying): ‘We feed you seeking Allah’s countenance only. We wish for no reward, nor thanks from you’”** (Al-Insān 76: 8-9).
- ▶ *Qur'an* urges believers to **spend what they love in order to achieve righteousness** (Al-‘Imrān 3: 92), **spend throughout their lives** (Al-Munafiqun 63: 10) and **the ideal** is to **spend whatever is beyond their needs** (Al-Baqarah 2: 219).

# Teachings Governing Economic Behaviour in Islamic Worldview



## Encouragement Towards Pure Altruism

- ▶ Prophet Muhammad (pbuh) declared that the **best charity is to spend (in charity) while you are healthy, aspiring, hoping to survive, and fearing poverty, and not delaying until death comes to you** (Sunan Abu Daud, Book of Wills, Vol 3, *Hadith* No. 2865).
- ▶ Allah wants the believers to avoid **miserliness** (Al-Nisā 4: 37). Instead of enjoining miserliness, Islam urges Muslims to **help one another in good acts and endeavours** (Al-Maidā 5: 2).
- ▶ Since Islam **only accepts pure altruism**, it promises numerous incentives for it in its two-worldly view of life. Several verses in *Qur'an* promise due reward for pure altruism (Al-Tauba 9: 121; Fatir 35: 29; Al-Hadid 57: 7).
- ▶ **Spending in charitable ways for the sake of Allah is compared to a good loan which Allah will repay with a manifold increase** (Al-Hadid 57: 11; Al-Hadid 57: 18; Al-Taghābun 64: 17; Al-Muzammil 73: 20).
- ▶ In several *Ahadith* also, **Muslims are encouraged to spend so that Allah also spends on them with His blessings** (Al-Bukhari, Book of Commentary, Vol 6, *Hadith* No. 4684).

# Methodological Framework For Studying Economic Behaviour in Islamic Economics

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- ▶ Assimilative Approach
- ▶ Distinctive Approach
- ▶ Integrative Approach



# Methodological Framework For Studying Economic Behaviour

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## **Assimilative Approach**

- ▶ Assimilative approach incorporates the mainstream economics methodology along with its value neutral framework.
- ▶ For “homo economicus”, i.e. economic man, it explores how it makes choices among ‘religious economic goods’ by allocating resources, such as endowments and time.





# Methodological Framework For Studying Economic Behaviour

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## **Distinctive Approach**

- ▶ Distinctive approach disregards both the methodology as well as the paradigm and epistemology of mainstream economics.
  - ▶ However, this approach is yet to build an analytical framework to study 'Islamic Economics'. Rather, it remains a critique of mainstream economics from the lens of spirituality which looks down upon materiality as an objective function.
  - ▶ This approach detests materiality as an objective function driving choice within not only non-economic, but also even economic sphere of life.
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# Methodological Framework For Studying Economic Behaviour



## **Integrative Approach**

- ▶ Integrative framework takes a moderate stance.
- ▶ It criticizes mainstream economics and its narrow focus.
- ▶ Economics is, but a small part of life and a small problem of man.
- ▶ Mainstream economics has shown it as the only problem and the only dimension of man and life.
- ▶ The integrative approach makes a distinction between economic and non-economic choices. This approach confines economics to only the economic sphere of life.
- ▶ It presents homo Islamicus as a human being desiring to live within the norms and rules of his faith.
- ▶ However, the integrative approach appreciates that this human being is not asked to detest life and resources.
- ▶ This human being has economic needs as well as spiritual needs.
- ▶ This approach incorporates pure altruism, pro-social allocation of resources and moral imperatives in choice set as the governing framework.
- ▶ Thus, it allows analytical and descriptive studies using mainstream tools as far as they can be useful in analysing and describing only the economic behaviour.



# Why Integrative Approach Could be a Starting Point



- ▶ Useful for **descriptive studies** about **economic behaviour** of **actual human beings** in **markets**.
- ▶ **Separation** of **economic and non-economic decisions**. This distinction does not necessarily depend on type of resource, i.e. economic and non-economic, but on objective, i.e. economic versus non-economic (**spiritual, pro-social, pure altruism** etc.).
- ▶ However, in some cases, the allocation of resource could be driven by pure spiritual stimuli, i.e. **spending on Hajj travel**. However, to fulfill this spiritual need, some economic goods will be purchased from markets. **All else same, one would prefer to economize on airfare, accommodation and food. E.g. If an online app delivers the same airline ticket, hotel room or food brand more cheaply than the other, then it would be chosen while one is undergoing Hajj journey.**
- ▶ In some other cases, the allocation of resource driven by spiritual stimuli might not involve buying an economic good, such as **donation**. In that case, avoiding such non-economic, but real and significant decisions outside of economics framework is a useful separation for analytical clarity and tractability.



# Why Integrative Approach Could be a Starting Point



- ▶ Self-interest can be pursued within morality and values.
- ▶ Take another example of separation of decisions based on motive in the integrative framework.
- ▶ Even if a person spends 5% of income on self-consumption and 5% of wealth on earning profits on investment,
  - ▶ He/she would not buy expensive *Halāl* goods for no reason when a cheap is available (when 5% of his/her *Halāl* income is spent on self-consumption).
  - ▶ He/she would not choose to buy good A instead of good B if prices of both *Halāl* goods are same and if he/she prefers B more over A (when 5% of his/her *Halāl* income is spent on self-consumption).
  - ▶ He/she would not choose to engage in behaviour where without any explicit or implicit cost, more profits can be earned than less in a *Halāl* business (when 5% of his/her wealth is spent on earning incomes).

# Why Integrative Approach Could be a Starting Point



- ▶ In economic pursuits, constrained profit maximization for firms after necessary modifications is a **useful framework to analyze why firms advertise, merge, acquire, build new plants, invest in research and development, innovate, introduce new products, re-engineer production processes and give discounts and promotions.**
- ▶ Since these decisions and activities routinely happen in the real world, the mainstream framework of constrained profit maximization is one way to contemplate and analyze the outcomes of these particular decisions.
- ▶ Indeed, in the Islamic economics framework, if that framework is adopted, more constraints can be added to incorporate Islamic values and norms:
  - ▶ In production set to exclude *Harām* goods.
  - ▶ In factor returns to exclude fixed compensation to money capital in the form of *Ribā*.
  - ▶ In the cost function to exclude investable resources set aside for *Zakāt*, *Sadqāt* and *Waqf*.



# Islamic and Mainstream Consumption Framework

Mainstream Economics Framework	Islamic Framework
The economic objective of a consumer is to gain maximum satisfaction when endowed with some positive, but finite resources.	Ultimate lifetime objective is to achieve Falah in both worlds and please Allah and this governs all human choices and actions.
Decision horizon is confined to this life.	Decision horizon incorporates a two-worldly view of life.
No cultural and institutional constraints beyond the law of the land.	Besides the law of the land, the preferences are shaped and influenced by moral imperatives.
Consumption set in every period is unrestricted.	Moral filter on consumption choice set. Thus, some missing markets.
Endowments can be obtained by providing labour for any gainful employment.	Endowments can be obtained by providing labour in permissible occupations.
Can use all means of investments to earn a return on savings.	Can use only Shari'ah compliant investments to earn a return on savings.
Can use interest based borrowings to increase/maintain consumption.	Can use only Shari'ah compliant finance to obtain specific durable goods.
Non-Satiation with respect to material goods.	Encouragement for pure altruistic behaviour.
Old people can dis-save all wealth by self-consumption or leave bequests.	Old people cannot leave bequests which are more than one-third of their wealth.
Policy intervention has to result in Pareto improvement in theory. Generally, the practice uses ad-hoc intervention.	Promoting <i>Maslaha</i> (social interest) and removing <i>Mafsadah</i> (social harm) govern policy.

# Points of Compatibility in Intertemporal Consumption

Mainstream Economic Framework	Islamic Framework
Desirability for consumption smoothing.	Encouragement for Wasatiyyah (moderation), which in one sense is also consistent with smooth intertemporal consumption.
People plan and save for contingencies, post-retirement life and to leave bequests. Neutral towards the end-objective of saving.	Can plan, save and leave bequests. Can also save for some religious acts like Hajj, Umrah, animal sacrifice and liquid savings to pay Zakāt by avoiding asset drawdown.
Desirability for variety and balanced consumption bundle.	The desire for aesthetic tastes, variety and spending on comforts recognized.
Substitution effect of increased returns on financial investments increases savings.	The instinct of substitution effect recognized. The total effect may still be altered by income effect.
Usually, a positive discount factor.	The instinct of desiring immediacy recognized in intertemporal choice and exchange.
Preservation of wealth through profitable investments.	Preservation of wealth recognized after payment of Zakah and by using Shari'ah compliant investment options.
Consumption on needs and beyond needs.	Besides essential needs, consumption of Halāl comforts and convenience goods is recognized.

# Why Integrative Approach Could be a Starting Point

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- ▶ The job of economics should be to explain the behaviour only in the marketplace.
- ▶ Behaviours can be completely contradictory across time and space. That is why, there can be completely contradictory theories, let alone a theory that will be deterministic or completely follow empirical evidence always.
- ▶ People can be selfish and selfless. Economists should not intervene in considering self-less behaviour as unreal, irrational or irrelevant.
- ▶ Likewise, to expect that people will have absolutely no regards for self-interest is also another extreme not supported by evidence.



# Why Integrative Approach Could be a Starting Point



- ▶ Islam denies the unrestrained pursuit of self-interest but allows flexibility within the *Halāl* choice set.
- ▶ Within that *Halāl* choice set, a person who does not commit excess in consumption and who pays *Zakāt* and *Sadqāt* generously can flexibly choose a means of transport one likes, the proportion of meat and vegetable in food one likes and so on.
- ▶ Thus, constrained profit maximization simply means that a company would try to pursue a profit opportunity that is available at no further increase in marginal cost.
- ▶ If a product is *Halāl*; marketing is within Islamic ethics and values; all contracts follow the Islamic laws of contracts and exchange; then, it is not a cause of concern if more output is produced when marginal revenue is greater than marginal cost.



# Do We Need DSGE Based Models

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- ▶ In a lot of empirical research areas, there is no need and relevance of GE framework.
- ▶ It can be good for expositional purposes, but one should not be handicapped by it.
- ▶ In a lot of empirical research areas in Islamic finance, GE framework is not required.
- ▶ Development & Environmental Economics too is not driven by GE framework for the most part.
- ▶ Monetary and Public Finance use GE, but with limited success, exactitude and confidence.
- ▶ Development Economics uses GE in theoretical formulation (E.g. Solow, Romer etc.), but policy is driven by **Differential Diagnosis, RCTs and Action Research.**

# Some Empirical Research Areas

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## ► Islamic Banking

1. Determinants of Profitability, Dividend Policy, Leverage, Credit Risk, Liquidity Risk.
2. Monetary Policy Transmission in a Dual Banking System.
3. Comparison of Efficiency in Comparative Banking Systems.
4. Interest Elasticity of Deposits and Advances.
5. Effect of Access to Islamic Banking on Growth, Employment, Investment, and Income Distribution.

# Some Empirical Research Areas

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## ► Islamic Asset & Wealth Management

1. Existence of Size, Value, Momentum, Profitability, Investment & Liquidity Premiums in Halal Stocks.
2. Computing Alphas of Islamic and Unrestricted Funds.
3. Investigating i) Market Timing, ii) Selectivity and iii) Diversification Ability of Islamic and Unrestricted Funds.
4. Performance of Style Portfolios Specializing in Premiums.
5. Testing CAPM, I-CAPM, Consumption CAPM, Conditional CAPM, APT, Multi Factor Models on Cross Section of Halal Stocks.

# Some Empirical Research Areas

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## ► Islamic Capital Markets

1. Are Islamic Capital Markets Weak Form Efficient, Semi-Strong Form Efficient and Strong Form Efficient?
2. Investigating Calendar Anomalies in Islamic Capital Markets?
3. Examining Signaling Hypothesis in Islamic Capital Markets.
4. Effectiveness of Trading Rules and Strategies in Islamic Capital Markets
5. Evaluating Reaction to News in Islamic Capital Markets
  - Profit Announcement
  - Dividend Announcement
  - Merger & Acquisition
  - Listing and Delisting
  - Shari'ah Eligibility and Non-Eligibility
  - Raising Debt and Equity
  - Stock Split and Repurchases

# Some Empirical Research Areas

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## ► Islamic Social Finance

1. Impact Evaluation of Islamic Microfinance Using RCTs.
2. Impact Evaluation of Zakat Using RCTs.
3. Analyzing Efficiency of Zakat Institutions.
4. Analyzing Efficiency of Waqf Institutions.
5. Effect of Zakat on Poverty, Aggregate Demand and Income Distribution Using Macro Data.
6. Effect of Zakat on Poverty, Aggregate Demand and Income Distribution Using Simulated Data.

# Some Empirical Research Areas

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## ► Behavioural Finance

1. Are Muslim Investors Averse to Risk and Loss?
2. Do Muslim Investors Herd or Do Islamic Capital Markets Exhibit Herding?
3. Are Muslim Investors Overconfident?
4. Do Muslim Investors Suffer From Disposition Effect Bias?
5. Are Islamic Capital Markets Driven by Investor Sentiment?

# Conclusion



- ▶ This paper discussed the different viewpoints about the right methodological framework to use in understanding economic behaviour of Muslims.
- ▶ This paper discussed the points of distinction and compatibility between the Islamic and the mainstream economics framework. It is argued that some of the Islamic principles and institutions can be integrated into the mainstream framework, especially in research studies where the objective is to understand and describe behaviour rather than persuasion and idealization.
- ▶ One of the mandate of Islamic economics can be to examine the effect on economic behaviour and on economic outcomes of institutions having an economic character and influence. This can be done using experimental and observational data and by applying statistical and other suited empirical techniques to establish analytical hypotheses.
- ▶ Islamic principles do not deny self-interest; rather they purify the self-interest through a social, moral and religious filter. A Muslim consumer will not only operate under a budget constraint, but also under moral constraints. In consumption and spending choices, the Islamic moral injunctions **are expected to** influence preferences through moral filtering of the consumption set.
- ▶ In producer behaviour, the explicit difference would come in the type of goods produced and the modes of financing used. The more significant and implicit difference would come in moral approach whereby an entrepreneur imbued with the spirit of ethos and philosophy of Islam **is expected** to avoid hoarding, anti-competitive behaviour, price manipulation, cheating, fraud, injustice and social harm in the form of negative externalities.



# Thank You

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For Questions, Comments and Feedback

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