Thesis of religion: normative basis of Islamic economics

Salman Ahmed Shaikh

International Association of Islamic Banks

16. September 2011

Online at http://mpra.ub.uni-muenchen.de/20289/
MPRA Paper No. 20289, posted 19. September 2011 12:46 UTC
Abstract

This paper discusses the ethical void in Capitalism which does not look prominent in welfare societies and states. But, its effects become more eminent in tough economic conditions. Unbridled pursuit of self interest, moral relativism, incentive-led economic choices and apathy to communal responsibilities would lead to a society where economic interests become the sole basis of maintaining and sustaining relationships. This inner void of identity and purpose at individual level and social void in the form of a stratified society bound together only for economic interests can be better filled with incorporating religion. Humans are much more than utility driven species, they are capable of using both instrumental and critical reasons to differentiate right from wrong and need reinforcement to adopt virtues influenced by an inner urge other than material interests as in Capitalism. This inner urge can be rekindled by looking beyond utility maximization to re-acknowledge the fundamental identity that humans are moral being than just an instrument for material advancement. Other sections of the paper provide an outline and salient features of Islamic Economics on different economic themes and perspectives for a comparative study. These provide a unique introduction to Islamic Economics in a mainstream framework.

1. Introduction: The Thesis of Religion

Morality is very eloquently discussed by Kant (1889/1785). He said that intentions define actions and not the consequences and not even compassion. He said that because compassion is temporary, a particular state and is not absolute. However, intentions best define the existence of morality in actions.

But, Kant did not give the method by which we could prioritize Maxims. For instance, truth and justice both are important moral values. But, what should we do if there is a conflict between the two? For illustration, if a person is known to us as murderer, but if we do not have witnesses to prove him as murderer in the court of law, should we give false testimony to convict that person?

Islam helps us to prioritize Maxims. Islam shows us that this world is not fair in all respects. A morally upright man is not necessarily the most honorable man in the world. A morally upright trader is not necessarily the richest in the world. Not all murderers have been or will be convicted in this world. Even if all murderers could have been
convicted, it will not be ‘naturally’ possible to give equitable punishment to the murderers who have killed more than one human being.

Even if it was possible, it will not be possible to reverse the immoral actions. What happened has happened and cannot be reversed. Death is the plainest truth and if justice cannot be provided in the life of a person; then, is it not rational to believe in life after death where everyone would be given equitable rewards and punishment for one’s acts and Allah by His infinite wisdom would be able to judge without any doubt the intentions behind the actions and justice will be provided to each and every one?

One can decide to do an act morally as an end in itself and not merely as means to a material end only with the knowledge of life after death and the belief in Allah. Moral act in Islam is also a means to an end i.e. to achieve eternal success and blessings of Allah. But, it is not a material end confined to this life only. In this way, the utilitarian mind is also satisfied as happiness is a relative term not achieved only by material things. The fact that moral actions even if they are not rewarded in this world will be rewarded in life hereafter satisfies the utilitarian mind.

We know what is right and what is wrong through our conscience. In matters where our conscience does not guide us, Allah intervenes and guides us through His prophets. Therefore, Prophets (peace be upon them) guide us in matters where we might not have reached the right decision about right and wrong through our conscience. For instance, interest, gambling, liquor etc. might seem useful and right; but, Allah tells us in Holy Quran that there is more harm in these things than good. (Al Baqarah: 219)

Today, we are seeing interest based system and gambling (speculative financial instruments) causing severe disorder in the economy. Similarly, the greatest asset of a human is his power to reason, his intellect, his use of wisdom and his ability to think. When we take liquor, we lose our greatest asset i.e. conscience and often do bad things which harm others also, besides us. For instance, we see people having accidents, people misbehaving with other women after taking liquor etc.

If one believes in this life only; then, that person will be more selfish to get everything in this life. If we restrict our existence confined to this world alone with no accountability in afterlife; then, I am "just" as long as I am "just" in front of the society even though there could be sins that society could have never seen me doing. Contrarily, I could be regarded as "unjust" by the society if it convicts me based on evidence which could have been untrue. Life hereafter gives all our actions the meaning by promising each and every soul the equal reward and punishment.

People can take justice in their own hands if they are allowed absolute freedom. We need institutions which can impose certain restrictions on all of us so that we can enjoy our freedom without denying freedom to others.
Islam is also such an institution which though put restrictions on one’s absolute freedom (as do all other systems), but Islam not only safeguards the rights of the people, but, more importantly and fundamentally, gives meaning to the life and to our own existence. We can use both reason and experience to believe in Allah. By way of reasoning, if we are creatures, then we are created by someone and that creator is Allah. The question that who created Allah is not valid as Allah is the creator and not the creature. Ultimate Creator needs not be created.

By way of experience, we can use empirical knowledge obtained from science to learn how the galaxies, planets, stars, rotation of the moon, rotation of the sun, rotation of the earth around sun works. How do millions of living beings sustain themselves in a universe in which even a tiny unusual interference can make life impossible on this earth? Why such a tiny interference does not happen and life continues to exist. All of this could not have been possible without accepting that this universe that is so perfect in its design was created and is being managed by Allah alone. Had there been more than one Allah, then there would not have been such ‘uniformity’ in the way we see universe and the way our planet earth works.

Furthermore, no meaning to life, world, man, his role and purpose can be explained without believing in Allah. Islam explains this by outlining our role that we have been created by Allah and sent in this world to be judged for our actions and will be rewarded in life hereafter if we follow the teachings of Allah i.e. to be just, kind, truthful, faithful, obedient and morally upright.

The fundamental value is freedom. Happiness results from it. Justice comes in to protect it. Humans, we see can become unjust using that freedom as speculated by Angels as well (Al Baqarah: 30). Can we provide justice and happiness in a paradigm of absolute freedom? Even when humans had little freedom in this world, we have seen them becoming unjust and then depriving the mission of providing maximum collective happiness for all.

The fundamental question is that can we provide perfect justice in this world. Can we have maximum happiness as we envision in this world. Are we or can we be absolutely free in this world?

What is of fundamental importance is the fact that this test has to be ‘just’. According to Islam, everyone would be judged based on his intentions, general attitude, general behavior, and general tendencies and most importantly in matters in which one has choice clarifies that this test is just.

How can a creation like this universe, having millions of stars, reachable not within centuries even at the speed of light, all so perfectly interwoven to make life exist and that too for some time as we do not grow to be immortal by way of evolution, be explained? Not only us, none of the species can escape from natural constraints and become immortal.
Everything in this world has been created in pairs. If there is thirst, there is water. If there is moon, it needs a sun to have its light reach us. If there is man, then there is a woman. Each one alone cannot live in isolation. They are all interdependent. Similarly, this world is incomplete without a belief in life hereafter.

This world alone shows us that few people get rewards which they do not deserve, while few people do not get rewarded even when they deserve, some go through severe illness, while some live a very healthy life, while some are unjust and yet they are not given punishment, some are honest and they do not get rewarded. All these incomplete events suddenly end when we die. Then, if no one will get equitable reward and punishment, then there will be no reason why they should wait for an afterlife. They can do all the wrong things if they can avoid the law. But, even if they can, they do not always do that, they have the ability to differentiate between right and wrong inbuilt into their souls. They would like to do good acts and avoid wrong acts.

Are we our own creators? Millions of species cannot just exist in such beautiful contrast without someone responsible for it. For someone to be an ultimate creator, the Supreme Being, He has to be someone beyond the constraint of this world and nature. If the premise is that Allah created everything and nothing exist independent of His will. Then, logical conclusion would be that This Supreme Being, Allah, has to be an independent personality having no constraints of nature.

If Allah is powerful in one thing and not in another, then He is not a supreme being. If Allah is omnipotent, then, we as humans cannot predict the behavior of Allah using examples of ourselves because our frame of reference is limited and we are creatures and not ultimate creators and we have constraints.

The question arises, if Allah is omnipotent, can He be unjust. Allah knows everything, but it has nothing to do with us having a freedom to choose our way of action. A teacher sometimes knows the fate of the students, but it is the student who makes his destiny provided the teacher is just. Allah's knowledge about a person has nothing to do with the trial in question. I can, by way of my expertise, predict the result of a cricket match, but it was not me who decided the result of the cricket match in the end.

If someone is my teacher, he has the power to fail me for no reason. But, if he is just, he will do justice and will not fail me; however, it does not mean that he could not do so because of his inability, but it is because he can not contradict his own attributes and values if he was consistent (as Allah is).

Allah is just as it will only hold us accountable for our actions in which we have choice. We will not be held accountable for color, race, creed etc. Therefore, everyone has an equal chance to succeed in life hereafter.

Religion provides the answer that this universe was created by a supreme being Who created it for a purpose. Science also confirms that because it has not at all provided
answers to "Why it is". In fact, science has shown that life cannot mathematically and statistically exist by chance.

We, humans have not just come in this world today and are now looking for answers. We have history behind us that tells that the Prophets came with the message of Allah and the nations which were "direct recipients" who disbelieved were punished in this world. Christians, Muslims and Jews, all believe in that history and it is our common heritage.

Shops, factories, computer programs, machines etc, are systems and they run and are operated by someone. Universe is also a system and is the most complex and a grand system. How can it just be 'the only system' that does not require a creator. All the systems mentioned above have some purpose. How can only this most grand system have no purpose?

Why there exists so much contrast in species? Why not some species just by way of chance found nothing that they could eat? Found to have body structure that is suitable in land, but they existed in sea or vice versa. The limited knowledge we have about each and every living thing and how they live and exist is just fascinating.

How could all species exist in circumstances which suit them with respect to geography, climate, body structure etc? Why then they still die and not evolve into immortality. We could not do it. None of the millions of species could do it. The extinction of species and our death signifies that someone who created us (humans) and took our lives will indeed be able to bring us to life again and that life would justify the purpose of existence and give meaning to this worldly existence.

Why none of the species became selfish enough to evolve differently so as to become a little bit superior to others etc. They would want to if they were all different kinds of animals because we as animals (if we take the evolutionists' stance) know that we are selfish to some extent, and want freedom from natural constraints.

If humans were little smarter animals, then they would have at least made some progress to get out of the natural constraints and succeed in a millions of years of history of evolution that evolutionists support.

If I am standing close to another person and if I am hit with a stick, why would only I feel the stick and not the other person? If we cannot sense each other, cannot get through our independent existence (considering we are the same types of animals), how can distinct species, one existing and one not existing, make way for each other in such a magnificent and perfect way in every detail that life becomes possible without an ultimate creator?

Can we avoid the question 'why' in any other matter of life? If we think that evolution defines a why or even if does not define it, it defines the material dispensation in this world and the human struggle and evolution in this world intellectually and physically,
then we ought to believe that all the bodies of knowledge are also one way or the other biological processes.

How do we differentiate between right and wrong? It has not gone through any evolution. Speaking truth is considered (I am not saying acted upon) a right thing throughout history.

If we are not creatures, just a manifestation of nature, then, there needs to be no reason to believe anything right or anything wrong, if we will just die without any accountability in life or hereafter for our actions, then, if we can avoid the court of law, we can kill, steal, hurt etc as long as no one can hold us accountable. But, we do not think and act like that. It is because we have conscience, ability to differentiate between right and wrong. Then, we have feelings and values, and in most cases, absolute feelings and values.

It makes this belief and argument very weak that this world and universe came out just other than by way of a creator creating it. Just like everything is created by a creator as we see it and observe it, this world and universe also has to be created.

It would be normal to believe like that as it will make us consistent. But, believing that every small thing, though insignificant, needs to be created by someone, but not applying this belief to the creation of the universe is erroneous. This universe could not have come about naturally. If species could co-exist naturally and fulfill their needs naturally, why they die?

A biological process cannot describe this complex set of choices we make through our conscience to uniformly identify right from wrong.

If we restrict the scope of evolution to some aspects; then, it cannot claim to take the place of religion which is a set of comprehensive doctrine i.e. a holistic system of beliefs and practices. If evolution is restricted in just describing how, then any description of 'how' (either correct or incorrect) does not in principle contradict with the thesis of religion. One cannot avoid the question 'why' though.

Social learning theory also cannot provide the wholesome answer because social learning requires for its acceptance and relevance, a history behind some of the values which gradually need to become sacred so that the society could force them on others to believe. In the start of life, nothing could be described as such.

Birds fly in winter to avoid cold. They have built-in map and take the best route to avoid flying over sea for most time. Birds few days old and doing it for the first time in life without access to books, journals and experience can never do that as perfectly as they do neither by way of evolution nor by way of social learning. Furthermore, the process, any process, may it be evolution or a sudden big bang, or whatever, does not give any answer to 'why'.
A question arises as to why we cannot just be able to see Allah and avoid having to solve this puzzle. We cannot see Allah, because Allah has sent us here for a purpose. That purpose would be meaningless if we could see Allah through our own eyes. But, we can observe, learn within ourselves and use our intellect to search for Allah and we will find the answer, but we have to be unbiased in our search.

2. Consumer Behavior Theory: Islamic Viewpoint

In the mainstream neo-classical economics, utility is assumed to be attained when the person himself/herself consumes the material goods which bring satisfaction, and not when he gives these goods to others. Mainstream economics allows people to have outright freedom in consuming whichever goods they like as long as they can afford them. Consumers seek maximum utility and do not have obligation to share their wealth with the poor masses apart from compulsory taxes.

This supposition has at least three problems when viewed from Islamic viewpoint.

First, with belief in Allah, a Muslim's scope of life and objective is different. His principal goal is to seek Allah's pleasure and succeed in the life hereafter. So; he is supposed to make every decision in a way to seek Allah's pleasure rather than pursuing self-pleasure and satisfaction.

Second, as per Islam, this world is a place for test and this test requires some people to be privileged and some to be deprived. The deprived and privileged are both tested for patience and thankfulness to Allah and how they take care of society and its needs. Hence, this worldview puts the focus of all human beings towards the fact that material resources they enjoy are all blessings of Allah and these are instruments for this test.

Third, as a corollary of point one, the focus of a Muslim shifts from materialism to fulfilling Allah’s commands of excelling in character wholesomely. Prophet Muhammad (PBUH) said: “Wealth is not in having vast riches, it is in contentment”.

An ideal Muslim will not indulge in lavish and conspicuous consumption due to prohibition of Israaf (extravagance even in lawful things), Tabzeer (consumption in unlawful things like liquor, free sex etc), Hasad (jealousy), and having to fulfill Allah’s commands and directive of Infaq (pay to charity), his independent and mutually exclusive choices in the wake of such controls will automatically bring about an optimal result for the society as well. Islam also creates a balance between seclusion/self-denial and lavishness. Prophet Muhammad (PBUH) taught that ‘your body has rights over you’.

Diminishing Marginal Utility upon successive consumption of a commodity is a natural phenomenon and approves of the limitedness of this world and what’s in it. The fundamental value is freedom. Happiness results from it. Justice comes in to protect it. Humans, as we have seen, can become unjust using that freedom. Can we provide justice and happiness in a paradigm of absolute freedom? Even when humans had little
freedom in this world, we have seen them becoming unjust and then depriving the mission of providing maximum collective happiness for all.

The fundamental question is that can we provide perfect justice in this world. Can we have maximum happiness as we envision in this world. Are we or can we be absolutely free in this world?

People can take justice in their own hands if they are allowed absolute freedom. We need institutions which can impose certain restrictions on all of us so that we can enjoy our freedom without denying freedom of others.

Islam is also such an institution which though put restrictions on one's absolute freedom (as do all other systems), but Islam not only safeguards the rights of the people, but, more importantly and fundamentally, gives meaning to the life and to our own existence.

Moral act in Islam is also a means to an end i.e. to achieve eternal success and blessings of Allah. But, it is not a material end confined to this life only. In this way, the utilitarian mind is also satisfied as happiness is a relative term not achieved only by material things. The fact that moral actions even if they are not rewarded in this world will be rewarded in life hereafter satisfies the utilitarian mind permanently and meaningfully.

3. **Islamic Perspective on Factors of Production & Distribution**

In an Islamic economy, we can classify factors of production as follows:

1. Land with natural resources.
2. Labor.
3. Physical Capital Stock.
4. Entrepreneur (Working as well as investing).

Below, we try to present details of our proposed classification.

**Land with natural resources** – It includes all things of value which are naturally occurring goods such as soil, minerals, land etc and that are used in the creation of products. The payment for the use of those resources in fixed supply is rent. When these are sold, their compensation is profit.

**Labor** – Providing physical or mental exertion by way of contract for consideration in the form of wage or salary. It does not include entrepreneurial labor as the compensation for entrepreneurial labor is the residual outcome of the productive activity and contains an element of risk and uncertainty.

**Physical Capital Stock** - It includes human-made goods or produced means of production. These are goods which are used in the production of other goods. These
include machinery, tools and buildings. The payment for the use of those resources in fixed supply is rent. When these are sold, their compensation is profit.

Physical capital stock and the factor 'land and natural resources' are differentiated on the basis of their source of existence. Physical capital stock includes human-made goods or produced means of production, whereas the factor 'land with natural resources' is not produced by humans. Both have the same compensation for their use. It is because while they are used, they do not lose their existence and hence they can be leased and traded.

One could argue that even when a production process hires a natural person providing labor, it does not consume that person and hence wage is basically the rent on human skills used. But, it is worthwhile to classify labor as a separate factor of production due to following reasons:

1) ‘Physical capital stock’ itself is dependent upon labor since it is man-made.

2) Termination of physical capital stock and labor from a production process could be different. When a person owning physical capital stock dies, rent will still accrue on assets in his/her ownership as long as the assets are in useful condition and as long as the contract of lease does not end. When a person providing labor dies, the factor payment ends instantly because the utility of labor or the capabilities of labor are intrinsic and are not detachable and transferable.

3) Physical capital stock is saleable and transfer of ownership is possible in them. But, in labor, transfer of ownership cannot happen. Since transfer of ownership is possible in physical stock, they can be recorded as assets.

4) Distinction has far reaching qualitative effects on behavior and management process. Expenditure on labor can only provide services or skills owned and possessed by labor which the labor willfully provides. He cannot be subjugated like physical capital stock or be traded. Only the skills are tradable and the supply of labor is much more in the hands of labor and consideration for the supply rests on factors much different from factors impacting supply of physical capital stock.

The classical economists also employed the word "capital" in reference to money. Classical economics include money with physical human made assets/goods in Capital. Money itself has no intrinsic value and is neither a rentable asset nor a tradable commodity as per Islamic principles. If capital is combined with labor, it “could” produce profit, but if money alone is lent, the interest it earns is not permissible as per Islamic principles. Interest is neither a justifiable reward of money nor capital. Money holder/owner has to convert it in one of the four factors of production namely 1) land with natural resource, 2) labor, 3) physical capital stock and 4) or become an investing entrepreneur to have any justifiable compensation out of the production process.
It is necessary that we properly name this factor of production. Else, it could allow one to mix up physical assets and money in the general word ‘Capital’. In classical economics literature, Capital takes different forms. A firm’s assets are known as its capital, which may include fixed capital (machinery, buildings, and so on) and working capital (stocks of raw materials and part-finished products, as well as money, that are used up quickly in the production process). Financial capital includes money, bonds and shares. In classical economics, investment which increases the capital stock is also priced the same way as capital stock. Hence, classical economics considers rent on machine and interest on money as one and the same thing and the classical economics only mentions ‘interest’ as compensation to capital generally.

**Entrepreneur** – It refers to an economic entity, natural person or corporation (juristic person), which undertakes the ultimate responsibility for the production process. It undertakes the responsibility to bear losses (if any) and is entitled to the entire residual positive economic outcome after rent on ‘physical capital stock’ and ‘land with natural resource’ and wages have been paid. Entrepreneur could be classified as *Working Entrepreneur* as well as *Investing Entrepreneur*. If entrepreneur is defined as an economic entity which is not entitled to a fixed compensation and that his/her compensation is based on the actual positive but residual economic outcome of the production process, then, we can introduce this classification. In Mudarabah, the Mudarib is the working entrepreneur and Rabb-ul-Maal is the investing entrepreneur. (Usmani, 2004)

By this definition and classification, we can avoid the very unnatural definition of land which also includes machines in traditional Income/Factor distribution literature in Islamic Economics. (Usmani, 2004)

By way of this classification, we are able to distinguish between assets which are natural resource and those that are human made. We are also able to distinguish between money and capital. Owner of money has to 1) buy land with natural resource and earn rent on it, or 2) need to buy physical capital stock and earn rent on it, or 3) need to become an investing entrepreneur in an Islamic economy to earn profits through enterprise. Money itself does not have any intrinsic value as per Islamic principles.

Furthermore, we are also able to include ‘human capital’ into the whole picture through our classification of ‘working entrepreneur’ and by separately including ‘labor’ as a distinct factor of production and qualifying ‘labor’ to also include ‘human mental exertion’.

4. **Islamic Perspective on Opportunity Cost & Time Value of Money**

Opportunity cost is a useful concept in Economics. Some Islamic Economists argue that Islamic Economics does not recognize or give consideration to opportunity cost. Below, we try to present why this is not an appropriate approach.
4.1. Explanation of Opportunity Cost

If I have a job paying me $1,000 and I decide to leave it and complete my PhD. Then, the opportunity cost of going to do PhD is $1,000 of job income forgone for me. When I am considering the option of doing PhD, I must also bear in mind this opportunity cost (implicit cost) along with fees and cost of books (out of pocket costs).

Opportunity cost of an activity is the cost of best alternative forgone in its place. (Parkin, 2003). If, for example, I had another job option paying $500, then, the opportunity cost will remain to be $1,000. It is because by not doing PhD, I would have taken one of the two jobs and I will have taken the one that pays me $1,000 over the one that pays $500 if I am rational. Then, the opportunity cost of going to PhD is $1,000 of job (best alternative of the two jobs) income forgone.

Just like I cannot ask or force the university to pay me $1,000 each month for me to do PhD with the satisfaction that I have not made any ‘economic loss’, similarly, the owner of capital cannot ask or force the borrower to pay him/her any stipulated increase over the principal amount in a loan transaction.

4.2. Time Value of Money & Islamic Finance

In investment for trade (which Islam allows), the investment goes through the entire process of a commercial activity that involves risk taking at each stage and any compensation on investment is strictly dependent upon the outcome of the commercial activity. The profit for the businessperson strictly depends upon the actual profit realized after taking market risk including price risk. It does not depend upon time. (Islahi, 1998)

Time value of money is the basis of interest. Time value of money is the problem for the investor to avoid keeping his/her money idle and to avoid forgoing the use of money that may bring positive value to his/her investment. However, it does not mean that the investor can demand an arbitrary increase (or is given as the case may be) as the cost of using money without taking the market and price risk.

Yes, the investor could seek ways to avoid earning an ‘economic loss’, but, for that, the investor cannot demand an arbitrary increase over the principal amount lent.

In a model Islamic economy, with closure of interest based Savings, Fixed/Term deposit accounts, more money will come in stock market either directly or through mutual funds. Primary market activities will increase since companies will no longer be able to generate finance through debt. Therefore, increase in listed companies will expand the market and diversify trading opportunities for investors.

This leads us to face the problem of how to price capital in corporate finance, which we discuss briefly hereunder:
In corporate finance, Nominal GDP growth rate could be used in following valuation models:

1. It will replace $R_F$ in Capital Asset Pricing Model.

2. It will help in calculating “$K_s$” and “Capitalization rate” in dividend discount model.

3. Income Bonds could be valued using Discounted Cash Flow approach. The proposed benchmark rate i.e. Nominal GDP growth rate could be used as the discount rate.

4. Free Cash Flow could be calculated using this benchmark rate.

5. In project valuation, this benchmark rate could be used to find Present Value (Indicative) of Cash Flows. This would be appropriate due to the following:
   
   i. It will not lead us into falling in time value of money as we are using an enterprise or output related benchmark rather than interest based benchmark.

   ii. The Cash Flows will be themselves obtained using equity contractual modes like Mudarabah and Musharakah.

   iii. We are calculating valuation models for the investor and not for the borrower. Borrower or financee will be in no obligation to provide the returns based on these valuations. But, the investor can use this “indicative valuation results” to rank investment alternatives.

   iv. In actual distribution of income between financier and financee, profit sharing ratio would be used and applied to the gross profit earned by the financee.

Conclusion

This paper discussed the ethical void in Capitalism manifested in unbridled pursuit of self interest, moral relativism, inventive-led economic choices and apathy to communal responsibilities. This has led to a society where economic interests have become the sole basis of maintaining and sustaining relationships. Marcuse (1964) has described this phenomenon as ‘One Dimensional Man’ in his book. This inner void of identity and purpose at individual level and social void in the form of a stratified society bound together only for economic interests can be better filled with incorporating religion. The Islamic perspective on different important mainstream economics concepts provides the much needed addition to the literature on Islamic Economics.
References:


