

## **THEORY OF THE FIRM, MANAGEMENT AND STAKEHOLDERS: AN ISLAMIC PERSPECTIVE**

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*This paper explores the impact of the behaviour of a firm and its management on its stakeholders operating within the framework of Islamic law and morality and draws a sketch of a socially responsible enterprise which Islam idealizes in the domain of business and trade. The study suggests that endogenising the ethical cum economic dimensions will enhance the efficiency level of the economy, and will also increase social welfare level.*

### **1. INTRODUCTION**

Behaviour of the firm is still a little understood matter. Why does one firm invest more than the other or what makes a firm enter or exit the market and what are the psychological factors that go into making a choice of this kind? These are questions that have not been fully answered (Foss, *et. al.* 2000; Dixit, 1989; Williamson, 2000). For example, Furubotn (2001) is of the view that ultimately, the theory of firm is linked to the theory of the state, whereas, Williamson (2000) narrated that religion played a large role at the level of social embeddedness. Simultaneously different economic theories are still unable to give us a clear understanding about entrepreneurship. Despite a number of academic contributions the concept of the 'entrepreneur' and the function of entrepreneurship in society have ranged extensively within theories (Pittaway, 2005).

In conventional economics, the theoretical model of the firm is generally based on the economic variables. The construction of an objective function primarily emanates from the maximization of profit and minimization of the cost. Seldom do

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they include social, ethical and moral components in this objective function. Firms enter the market when they are observing a higher profit and exit the market when they observe losses in economic terms. Opportunity cost is a pure economic phenomenon (Bilas, 1983; Naqvi, 1994).

However, a firm as an integrated part of society has some moral and ethical obligations. At the time of formulating their objective function, they have to incorporate social, cultural, moral and ethical variables besides the economic ones (Morrison, 2000). However, very limited studies can be seen in this area including religion as a variable in their discussion, e.g. the study of Anderson *et. al.* (2000) explores the role of religion in the formation and development of the enterprise culture. It is the moral and social responsibility of the firms to care for their stakeholders while they are in the process of earning (Sen, 1993; Boatright, 2002; Zaman 2005; Mannan, 1992d).

Fortunately, the Islamic framework guides the economic agents towards the positive as well as normative aspects in all fields of life. We have the same guidance in the theories of economics, e.g. the theory of consumption, theory of production, theory of distribution and so on. The main objective of a Muslim entrepreneur is based on reasonable profit, just price, just wage and the welfare of society. It is recommended that the entrepreneur should include the above mentioned four components in his/her objective function for the benefit of society (Choudhury, *et. al.* 2006; Azid *et. al.* 2008).

The main objective of this paper is to analyse the theory and practice of firms under the divine guidance of Islam. This study is organized in the following way. Section I discusses in brief the theory of the firm. Section II presents the theory and behaviour of the firm under the umbrella of Islam. The last section summarizes and concludes the paper.

## **2. THEORY OF THE FIRM**

The firm is an important entity through which economic activities are organised in societies. A number of attempts can be found in the literature related to its different dimensions (for example Foss *et al.* 2000; Coase, 1937; Ricketts, 2002). However, its theory is still relatively new in the field of academics. In a market economy, the firm's role is significant and remarkable; it manages the factors of production and also plays an important role in enhancing the market mechanism. For academia as well as for policy makers, the firm's related variables such as cost, price, and method of production are vital to discuss. It is astonishing to know that conventional economics has still not been able to find the major causes why firms are working in the market and why they have a different structure. However, from Adam Smith up to now the mainstream of economists consider that firms allocate their resources in an optimal way if they work under the umbrella of a free market. In the modern age, the firm becomes a very important economic institution (Samuelson and Nordhaus, 2001; Richard and Kenneth, 1980).

The advancement of technology is another important phenomenon, which is related to the size and structure of the firm. The productivity of the firm is based on the level of technology that it applies (Mathur, 1989). What is worth considering is the patent of the technology and the product. These will make the firm more productive and more efficient through economies of scale and scope. However, due to monopoly power, these firms tend to exploit smaller firms and resources in effect creating social problems, which should be controlled by the public authorities (Garvey, 2003; Mathur, 1989).

The theories of neoclassical school have played a very important role in the development of economics through the concepts of utility, opportunity cost, marginalism, price theory and market mechanism. These theories explained very well the "invisible hand" of Adam Smith and intelligently discussed the competitive market structures as well as the monopolistic ones. However, evidence proved that the behaviour of the firm cannot be determined under these two market systems. Later, they discovered the importance of imperfection of the competition and then explored the oligopolistic market structure, monopolistic market structure and so on. Even the firm's allocation of resources does not follow the price mechanism (Weintraub, 2002; Samuelson and Nordhaus, 2001).

The structure and nature of firms has been changed because of mass production and multinational and transnational business activities. This has led to the emergence of a new character of the firm whereby the ownership of the property does not necessarily imply its control. A revolutionary change has occurred in its framework, a new class in the organizational set-up of the firm has emerged, which controls and employs the property of others. This has changed the direction of the theories and practice, because ownership and control are now two different issues. As a result, new issue of principal - agency relationship has emerged in the model and structure of firms (Berle and Means, 1932).

In the above framework the traditional model of a neoclassical firm is not working properly and the nature of the economic and legal relationships has changed. New theories were developed to consider the new phenomenon and transaction costs got the key position in these models. It has been admitted that no one has perfect knowledge about the future so the market phenomenon was replaced by agreements and contracts between firms, management and workers. This signifies the failure of the market mechanism and the desperation by the believer of it (Joskow, 2002; Pittaway, 2005).

The world of free markets is transformed into the world of agreements and contracts, refuting partially if not fully the notion of perfect knowledge of markets and its mechanisms and demand and supply now became a specific instead of a general phenomenon. In the radically changed circumstances of the firm, everything is based on how much negotiation power and required skill one has in the chains of contracts and agreements. How much unskilled owners might be, they

rely on the negotiations of their representatives (Williamson, 1984 and 1989; Pittaway 2005).

It is admitted that every option cannot be anticipated or estimated in this world of uncertainty. So, the theorists have the consensus that in this situation the government should intervene and make laws about the working of firms, e.g. law related to partnership, corporate, agency, etc. It was deeply felt that protection should be provided to stakeholders of the firms from the different social and economic costs (Garvey, 2003; Ricketts, 2002).

### 3. MANAGERIAL RESPONSIBILITIES

In the literature on this subject we can find two main approaches related to the relationship between the managers and the firms:

#### 3.1 Maximization of the Profit of Shareholders

According to this approach, it is the utmost aim of the management to maximize the profit of the shareholders and it is the duty of the management to look after their financial interests. They have to make the choice between debt and equity, because most of the financial transactions in the conventional system are based on debt, and a major part of the cost is the amount of interest. Other stakeholders (consumers and workers of the firms) should protect themselves through the law, contracts and agreements. This approach has economic considerations, which are absolutely related to the shareholders of the firm (Blair and Stout, 2001).

#### 3.2 Protecting the Interest of Stakeholders

This approach considers that firms are an integrated part of society and community. So, it is the moral and ethical duty of the firm to look after and protect the interests of all the components of the firm and society. This approach encompasses both normative as well as positive aspects. The proponents of this approach argue that firms should look beyond the maximization of the returns of their shareholders (Turnbull, 1997; Jones, 1995), and should adopt a wider perspective of stakeholders which includes the customers, society, and environment.

Kakabadse *et al.* (2005) presented an extensive review on the stakeholder approach and expressed that corporate social responsibility (CSR) and stakeholders' interests are partly related to each other.<sup>1</sup> In line with this, Hillman *et al.* (2001) listed the core of the stakeholder theory as: "(1) the firm has relationships with constituent (stakeholders) groups and the processes and outcomes associated with these relationships of interest; (2) the interests of all

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<sup>1</sup> "There is a natural fit between the idea of corporate social responsibility and organization's stakeholders. The concept of stakeholders personalises social or social responsibilities by delineating the specific groups or persons business should consider in its CRS orientation". Carroll (1991:43).

legitimate stakeholders have value; and (3) the focus of stakeholder theory is on managerial decision making". Kakabadse *et al.* (2005), therefore, concluded that managers should pay attention to stakeholders. In the literature, some sub-categorization has been developed because of the broadness of the term stakeholders, i.e., external/internal stakeholders, primary/secondary stakeholders, voluntary/involuntary stakeholders and social/non-social stakeholders. In classifying the stakeholders, Carroll (1991) provides the following categories: "shareholders (or owners), employees, customers, suppliers, local community, interest groups (or sometimes civil society representatives, though slightly more inclusive in definition), government, the media, and society-at-large".<sup>2</sup> Kakabadse *et al.* (2005:294) also considers the environment as a stakeholder. They believe that as part of the pro-active corporate social responsibility, and of sustainable growth, the firm is expected to maximise the interest of non-shareholders stakeholders, which includes the environment.

The first approach is already acceptable in theory and practice and the second approach has made its room in literature but is still trying to get a place in practice. In this modern era of advanced information technology, specialization and organization is becoming the nucleus of the economy. Among the different economic agents like consumers, employees and managers, the latter has more power because of their organized stature. It is clear that whoever has more power has more responsibilities. It is obvious that the manager's role has a significant impact on the benefits and costs for the society and community (Garvey, 2003; Garry *et al.* 2005). Hummels (1998) explained the ethical aspect of the managerial stakeholder theory as: "the role of management to balance all the (moral) rights and interest involved, while at the same time safeguarding the objectives of the firm". Hitt (1990), Minkes *et al.* (1999), Punter and Gangneux (1998) and McAdam and Leonard (2003) express the importance of the role of the leaders in the organization specifically towards the ethical issues. Minks *et al.* (1999) further added that not only the top management but also the middle management has to play its role towards CSR.

From the above discussion it is concluded that the responsibility of the firm is not only to fulfil its economic objective but it is also the duty of its management to look after the social and economic interests of all its stakeholders.<sup>3</sup>

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<sup>2</sup> "Some of these terms by themselves raise significant problems in relation to the value of organizational accountability to stakeholders, especially 'society-at-large' and the notion of community". (Kakabadse *et al.* 2005:294).

<sup>3</sup> For more detail of the second approach see Freeman (1984), Cornell and Shapiro (1987), Donaldson (1989), Sen (1993), Baum *et al.* (1994), Blair (1995), Donaldson and Preston (1995), Jones (1995), Turnbull (1997), Zingales (1997), Tirole (1999), Boatright (2002), Simmons (2004), Kakabadse, *et al.* (2005), among many others.

#### 4. AN ISLAMIC THEORY AND FRAMEWORK OF THE FIRM

Early Muslim scholars had also discussed the behaviour of firm and management and their responsibilities towards society and community (Tahir *et al.*, 1997). It is a well known phenomenon that the Islamic system of governance works on the principle of no-injury or principle of *maṣlaḥah* (Bashir, 1997). The early works of jurists are also based on these two principles. It is established that worldly goods are for the advantage of all and no one has the right to use these goods to cause a loss to the other members of society. Islam gives training to man on how to develop morals, and how to use these morals to bring faster economic coordination. However, the organization of firms in the past was not as complex as it is in the present age. This requires extensive work to understand the modern firm's behaviour in an Islamic framework.

Islam has its own rules, laws and regulations towards the nature as well as the economic perspective of the firm, which are to some extent different from the conventional system. The Islamic norms are expected to change the policies and directions of the businesses. Although we do not find any restriction on establishing firms in this system, the Islamic system appreciates the investors, business initiators and the role of the entrepreneur in the reduction of poverty, and considers a firm with such objectives as a benefactor of the community yet the functioning of the firm is guided by the teaching of Qur'ān and *Sunnah*. In other words, Islam calls for socially responsible businesses. Mannan (1992d) pointed out that two basic questions should be considered whenever someone tries to analyse the behaviour of the firm:

- (i) What contribution is the output of the firm going to make?
- (ii) Who are the beneficiaries of the value-added component of the product of the firm?

In reflecting on the complementary nature of firm analysis across cultures, Iqbal and Mirakhor (2003:58) content that "In Islam, expected behaviour of a firm would not be any different from the expected behaviour of any other member of the society".

##### 4.1. Firms and Right to Property in Islam

Islam teaches the entrepreneur about the aspiration for betterment, striving to continuously overcome the self, and a journey from selfishness to altruism. Altruism in terms of taking decisions towards the determination of output and price; Islam opposes the axiom of selfishness, whereas, principle of self-interest is permitted as narrated by Tag El-Din (2008) "... the pursuit of self-interest has been acknowledged as the driving force in market exchange, well before the appearance of modern economics, though within the ethics of decency, good sense and mutual consideration". Tag el-Din has further discussed the concept of self interest by using the terms of *mushaha* and *mughbana* (underrating and haggling). Kahf

(1992a) comments that all types of industrial activities and relations, which degrade the human being or make them party to the vices for the sake of economic gain, are not allowed in this system. It should be noted that while self-interest, and hence market mechanism is accepted as the motivation and centre for exchanges, respectively, Islamic economics requires market to work with “cooperation, compassion, justice, charity and solidarity” (Ahmad, 2003:195) to also produce a socially acceptable optimality alongside economic efficiency. Thus, the Islamic firm is expected to uphold such social expectations in order to reach a sustainable economy and society.

From an Islamic point of view the entrepreneur has the right to own private property and economic resources, make a profit, expand jobs, boost investment and increase prosperity. Therefore, Ahmad (2003:195) confirms this by stating that “private property and private enterprise are affirmed as inalienable rights and a natural mode for economic activity”. It is important, however, to note that the concept of ownership is not absolute in this system. The position of human being in this world is as a trustee and all the resources are given by God to individuals, so their duty is to utilize them according to divine guidance (Qur’ān and *Sunnah*), i.e., a conditional utilization of resources. In other words, “the very concept and function of property is transformed by the provision of moral and legal filters, and instilling in people’s minds and hearts the notion that all in its forms –physical and human, machine power and brain power- property is a trust (*amānah*), and as such, property rights are subject to moral limits and used as a means of fulfilling ethical objectives – the *maqāṣid* al-Sharī‘ah (the objective of the Islamic way)”, (Ahmad, 2003:195).

It is a common understanding that the utilization of resources on a non-economic basis is considered as oppression and in this situation the right of utilization will tend to zero. However, death is considered as a natural end of one’s property right. Islam demands professionalism from the entrepreneur and guides human beings not to betray the profession solely on profit (Kahf, 1992a; Iqbal and Mirakhor 2004; Azid *et. al.* 2008).

Iqbal and Mirakhor (2004), among others, discuss in detail the rights of property in the Islamic framework and concluded that private property is recognized in this system but not allowed to violate the rights of the society and the state. Therefore, Ahmad (2004) suggests moral limits as a filter to overcome conflict between social and private claims over property rights. However, if someone has discharged the duties to the society and state then he has a full right to possess that property. Therefore, Iqbal and Mirakhor (2004:52) state that “Basic conditions to maintain lawful acquisition to property are that (1) property should not have been acquired by unlawful means (means repugnant to Sharī‘ah), (2) the acquisition and its continuity should not result in any damage or harm to others; and (3) the acquisition of property should not invalidate any valid claim nor should establish a non-valid one”. In terms of legal positioning, firm’s property rights also

come under the same rules of Shari‘ah as individuals. How individuals should manage their property is observed from the Qur’ānic verse (4:29)<sup>4</sup> and also the Prophet advised not to waste resources, property and wealth.<sup>5</sup> These rules of ethics, hence, apply to firms as well.

Property rights are necessary for determining market exchange and are also key for the definition of stakeholders of the Islamic firm. Iqbal and Mirakhor (2004:57), therefore, emphasized that an Islamic firm is expected to preserve the property rights of its stakeholders<sup>6</sup> in arguing that “in Islam, a stakeholder is the one whose property rights are at stake or at risk due to voluntary or involuntary actions of the firm”.

#### 4.2 Firms and Nexus of Contract

In the conventional literature of economics, theories of the firm may roughly be classified into two categories (a) incomplete contracting model and (b) principal agent model<sup>7</sup> (Foss *et al.* 2003:634).

In stressing the incomplete contracting model, Foss *et al.* (2003:636) state that “the firm is nothing but a nexus of contracts, backed up by special legal status and characterized by continuity of association among input owners”. In supporting this, Holmstrom and Milgrom (1994), therefore, view the firm as ‘an organization’, particularly as a logical set of corresponding contractual arrangements, which

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<sup>4</sup> O ye believe eat not up your property among yourselves in vanities; but let there be amongst you traffic and trade by mutual good will: nor kill (destroy) yourselves: for verily Allah hath been to you most merciful! (4:29).

<sup>5</sup> Related sayings (*ḥadīth*) of the Prophet of Islam: “Keep your property to yourselves and do not squander it.” (Bukhari); “Allah disapproves for your irrelevant talk, persistent questioning and wasting of wealth.”(Bukhari); “The messenger of *Allah* forbade to debase (or scrap) the currency of Muslim except that there is a danger (of its misuse)”, (Bukhari).

<sup>6</sup> “Principle of property rights in Islam clearly justify inclusion of stakeholders into decision-making and accountability of an economic agent’s activities. This inclusion is based on the principle that (a) collectivity (community, society, state) has sharing rights with the property acquired by either individuals or firms (b) exercise of property rights should not lead to any harm or damage to property of others (including stakeholders), (c) rights of others are considered as property and therefore are subject to rules regarding the violation of property rights, and finally (d) and property leading to the denial of any valid claim or right would not qualify to be recognized ‘*al mā’l*’ and therefore will be considered unlawful by Shari‘ah.” (Iqbal and Mirakhor, 2004:54-55).

<sup>7</sup> “(a) Incomplete contracting models which are founded on the assumption that it is costly to write elaborate contracts, and that there is therefore a need for ex post governance. The work of Williamson; Grossman, Hart and Moore; Coase; and Simon, as well as implicit contract-theories, and the theory of communication in hierarchies, belong to this category. (b) Principle-agent models which allow agent to write elaborate contracts characterized by ex ante incentive alignment under the constraints imposed by the presence of asymmetric information. The work of, for example Alchian and Demsetz; Holmstrom and Milgrom belong in this category.” (Foss *et al.* 2003: 634).

lessen incentive differences. However, within this logical structure of firm perception, incomplete contract understanding has a significant place. For instance, Coase (1937) and Simon (1951) discussed the incomplete contract in relation to firm analysis in great detail. Coase (1937) elucidated implicit contract (unwritten code of conducts), while Baker *et. al.* (1997) argue that implicit contracts occur both within firms (in the employment relationship) and between firms (relational contracting). Williamson (1975) extends the discussion of nexus of contract by introducing the short term (spot market) employment and non-contingent output contract (long term).

Iqbal and Mirakhor (2004) discussed the governance of the corporate sector and its contracts under the umbrella of Shari'ah. The foundation of their argument is that there exists a contract of human beings with Allah (swt), and also they argue that contract is a time-bound instrument. Consequentially, reward and punishment are linked with the fulfilment of obligations in relations to contracts. They further added that in the contractual process intention is more important. Over and above, in their opinion, both have room in the system of Islam.

Form the literature on Islamic jurisprudence, it is observed that cornerstone of the contract is offer (*ijāb*, defined as the primary action) and acceptance (*qabul*, defined as the secondary action), whereas offer and acceptance cover two issues, i.e., language (*sigha*) and nature (*sifa*). However, in general three cornerstones are compulsory for a contract, parties to the contract, language of contract and its object. It is desirable that all contracts should be written and signed by the witnesses.<sup>8</sup> Some ethical conditions are as: i) avoidance of excessive advantage, ii) truthful and complete disclosure of information, iii) avoidance of swearing, even truthful, etc. A contract must satisfy these four conditions as: i) conditions of conclusion, ii) condition of validity, iii) condition of execution and iv) binding condition. Two conditions under one contract are forbidden<sup>9</sup> (Al-Zuhayli 2003). During the process of contract it is not allowed to swear even both of the parties are truthful.<sup>10</sup> An argument is also presented in the literature that corporate morality as an analogue to individual morality (Iqbal and Mirakhor, 2004; Jones, 1995).

The Qur'ānic verse states that "ye who believe! Fulfil obligations" (5:1). This verse has two dimensions: firstly, there are the divine obligations that arise from spiritual nature of human beings and its relation to Allah (swt); secondly, the human being undertakes mutual obligations in its human and material life, express

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<sup>8</sup> Qur'ān (2:282).

<sup>9</sup> Saying of Prophet (pbuh) "the following are not permitted: a loan sale in one transaction, two conditions in one sale, profits on goods that were not guaranteed, and selling that which you do not have" (quoted by Al-Zuhayli 2003:117).

<sup>10</sup> Saying of Prophet (pbuh) "Swearing destroys the goods, and wipe out their blessing" and it is also criticized in the Qur'ān "and make not Allah's name an excuse in your oaths against doing good or acting rightly making peace between persons" (2:224), (quoted by Al-Zuhayli 2003:7).

and implied. So this is the duty of human beings to discharge all their obligations faithfully whatever the nature of the obligation, explicit or implicit. The fulfilment of the obligations is considered as one among the good deeds<sup>11</sup> and, therefore, Allah (swt) loves those who fulfil their obligations.<sup>12</sup> If someone does not fulfil his/her obligations he/she is declared as faithless.<sup>13</sup>

If the origin of contract is injustice and unfair, the Shari'ah does not admit it as a valid contract. The Prophet (pbuh) has forbidden a number of pre-Islamic contracts which have *gharar* and vagueness. For instance, Zaman (1991:119) states that "the contracts of *munabadhat* (a method under which the buyer was bound to purchase the good thrown at him by the seller), *mulamasat* (a method which bound the purchaser on his touching the merchandise) and throwing of stones (throwing of stones known as *hasat* bound the purchaser to purchase the heed which his stone struck in a herd of cattle), etc. All these techniques were conventionally prevalent but the Holy Prophet (pbuh) disallowed them because of their defiance of the spirit of the Shari'ah".

It is observed from the above discussion that the main objective of the Shari'ah is to create the environment of justice and benevolence through its rules and injunctions in each and every activity either that is economic, business, social, cultural or political.

### 4.3. Scale of Efficiency

In the Islamic system the economic differences between individuals are never ignored. This stratification is necessary for lively economic activity (Tabakoglu, 1983; Khan, 1975; Mawdudi, 1969; Qutb, 1968). Islam appreciates skill and experience and permits hierarchy (Khan, 1975). On the other hand, the concept that some families are born with preferential rights and the workman has to toil for these few families is unacceptable in any phase of social life (Qureshi, 1959). Profit and earnings must be according to the profession, skill, risk to life and health, and the depreciation of the health and physical strength of the workman, location, climate, environment and conditions. Eventually this world is a trial for everyone instead of superiority (Tabakoglu, 1983).<sup>14</sup> However, it does not mean that in an Islamic society, differences should be treated in a discriminatory manner. In an Islamic state every citizen is equal; the only consideration is the level of his skill, training and efficiency in the context of earnings and profit (Azid, 2005).

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<sup>11</sup> Qur'an (2:177).

<sup>12</sup> Qur'an (3:76; 16:91; 13:20; 23:8).

<sup>13</sup> Qur'an (2:100 and 8:56).

<sup>14</sup> Such principles are observed in the following Qur'anic sources: "And for all there will be ranks from what they do." (46:19); "He it is who hath placed you as viceroys of the earth and hath exalted some of you in rank above others, that He may try by you (the test of) that which He has given you." (6:166).

#### 4.4. Cooperation among the Factors of Production

From the teachings of Islam it has been observed that its economic system has two important components; participation and cooperation. Thus, in the organizational set up of an Islamic firm, participation and cooperation of every economic agent is required for the best utilization of the resources and may be the optimal strategy. Islam has no objection on the best utilization of the resources but not at the cost of society's benefit.

There should be cooperation in between labour and capital (capital may be defined in terms of human, social and cultural assets) for the solution of social problems. As a result, there should be less strikes, creating a healthy domestic, social and moral environment.

Furthermore, Islam does not refute the importance of capital as a factor of production, but also considers labour as a basic source of value. The Islamic economic system does not separate both factors of production from each other and presents the solution of the conflict between labour and capital. It is observed from the Qur'ānic verse<sup>15</sup> that everything produced by God is in due balance, so these factors of production are not a perfect substitute but to some extent are complementary to each other. No doubt everything is produced by God for the benefit of humankind (Faridi, 1955; Tabakoglu, 1983; Khan, 1975; Uzair, 1983; Azid 2005).

#### 4.5. Obligations towards Customers

An Islamic firm, as part of the ethical economy, is expected to undertake its economic activity in line with normal conduct as enshrined in the Islamic tradition which includes its relations with the customers. In this point also the difference between current market mechanism and the Islamically oriented market mechanism appears, that while market mechanism and its competitive nature is accepted, it is expected to work with cooperation and its activities should be filtered through an ethical social filter. Due to such an ethical approach, it is the responsibility of the firm to provide its customers exact information about its products: type, origin and cost of production. Islam guides firm's behaviour towards its customers.<sup>16</sup> Exchange should be beneficial to both the parties. However, unbeneficial exchange (the exchange of one coin for an identical one), the exchange of bads (e.g. items of no worth, dead animals or dust), unlawful commodities (e.g., pork, wine), or exchange having those elements which are not allowed by Shari'ah, such as gambling (*maysir*), interest (*ribā*), intolerable degree of uncertainty or ignorance

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<sup>15</sup> Qur'ānic verse provides insight: "And produced therein all kinds of things in due balance" (15:19).

<sup>16</sup> Saying of Prophet (pbuh) , "All merchants are resurrected on the day of judgements as sinners, except for those who feared Allah, treated their customers well and were truthful" and "Allah is merciful to the man who is easy when he sells, when he buys, and when he collects his loan" (quoted by Al-Zuhayli 2003:7).

(*gharar*, or *al-jahālah*), intimidation, time-restriction, uncertain specification (*gharar al-wasf*), harm (*al-dārar*), and corrupting conditions (*al-shurut al mufside*) are excluded from legitimate exchanges in the Islamic tradition (Al-Zuhayli, 2003).

The conventional theory discusses in detail about the disputes between buyers and sellers concerning product quality and whether a claim of poor product performance is covered by a warranty issued by the seller (Palfrey and Romer, 1983; Alger and Salanie, 2006). Recalls and other remedies are usually conducted voluntarily by the manufacturers (Welling, 1991). In contrast to this, ethical principles (trust, trustworthiness and cooperativeness) are the basic ethos of the Islamic culture and a significant attribute of the Islamic firm. Therefore, for instance, breaching the trust by someone is declared as a sign of *munāfiq* (hypocrite, without religion).<sup>17</sup> Above and beyond, the concept of brotherhood plays a remarkable role in the process of exchange, warranties, recalls and contracts (*ex ant* and *ex post*),<sup>18</sup> also it is the one of main sources to mitigate the dispute among the customers and firms. Moreover, such an ethical conduct of business on the side of firms in relation to customers creates the environment of social justice and good relations. This is indeed an important requirement of the Islamic tradition in business transactions, as the major requirement is to create the environment of justice in economic exchange.<sup>19</sup> No doubt, firms under the umbrella of Islamic ethos are business organizations but simultaneously they are also guided by the Sharīḥ to be generous towards their customers. Thus, in this morally guided environment (endogenously trained society) the disputes among the firms and customers (related to warranty claims, recalling, product quality, etc.) can be resolved with minimum exogenous instruments due to the mechanisms inherent in the Islamic construct of the firm.

#### 4.6. Principles of an Islamic Firm and Social Responsibility

The objective of the Islamic firm is not only to maximize profit (Siddiqi, 1992a, 1992b), but also maximize social optimality as requested by the accountability and *khalīfah* (Ahmad, 2004; Naqvi, 1994; Yusof and Amin, 2007) axioms of Islamic economic system's foundational principles. The moral filter and the Islamically informed business behaviour of the firms is reasonable, fair level, moderate degree or satisfactory profit, and therefore strict avoidance of excessive profit is the norm of the Islamic firm, because the preference is for the moral and ethical values (Islamic injunctions or Islamic rationale) instead of economic rationale. Al-Zuhayli (2003:7) points out that "The Maliki scholars defined excessive disadvantage as a profit of one third or more, since that corresponds to the rules of limited will. Therefore, a profit rate of one third or less is considered acceptable".

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<sup>17</sup> Saying of Prophet (pbuh) "The truthful and honest trader is among the prophets, the righteous, and martyrs" (quoted by Al-Zuhayli 2003:6). see also footnote 28.

<sup>18</sup> Qur'ān (21:92) and (23:52-54).

<sup>19</sup> Qur'ān (6:152).

It is indeed also the case with the Islamic firm theory that the entrepreneur has to fulfil his/her material as well as spiritual desires. The entrepreneur should discover new methods for the maximum satisfaction of the needs of society and also hidden energies of the different components of the firm should be explored. He should supply the necessities, social goods and services at lower prices, divert the resources from luxuries to socially desirable goods and services. It is also not recommended that moral qualities should not prevail over entrepreneur's readiness to risk his resources to such an extent as to dry up every creative impulse (Yusof and Amin, 2007). Mannan (1992c) is in the opinion that if the firm observes negative profit then the state should provide some support. On the other hand, there are also some constraints imposed on entrepreneur, not to employ those procedures of production which are not quite honest, not to realize unlawful profit, not to sacrifice his moral dignity to allurements of material goods, not to cheat his competitors, not to accept bribes for the maximization of his profit, and also not to harm the environment. He has a greater desire to alleviate the suffering and miseries of the deprived segment of society.

According to the neoclassical school of thought, greater production and profit actually enhances the social welfare of society. The optimal allocation of resources maximizes the social welfare (Pareto optimality: gain of someone without the loss of others). This is measured through the scale of utility or profit. In a nutshell, we can say, in the neoclassical world, the firm, through efficient allocation of resources, increases the social welfare of society. "The idea of finding a definitive optimum (comparable to a classic Pareto equilibrium) has no clear meaning." (Furubotn, 2001:138). Furubotn (2001:139) further added as: "...cannot be expected to achieve the classic efficiency results suggested by the neoclassical model ... different firms in the industry will end to reach different solutions". However, in an Islamic firm, the only purpose is not to maximize its own profit but also to look after the other components and the stakeholders of the firm, especially the deprived segment of society. An Islamic firm must avoid all acts of exploitation, discrimination and restrictive trade practices, since all these are denounced by Islam. Behaviour should be towards justice and benevolence norms of business policy. It is a well known fact that when managers try to maximize the profit of their shareholders, often the cost of this maximization is paid by the consumers with high prices, or paid by the employees through accepting lower wages. This has moral externality and a negative impact on the working conditions of the firm. Maximization of profit at the cost of social welfare is not acceptable and not appreciated. As part of the social welfare, paying charity is the religious as well as a social norm which is believed to purify the sales of the firm.<sup>20</sup> It is admitted that profit is the life of the business, but other factors like moral, social and ethical values have their own value in the life of business (Al-Zuhayli, 2003).

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<sup>20</sup> Saying of Prophet (pbuh) "O merchants, the devil and sins are present at each sale, so purify your sales with charity" (quoted by Al-Zuhayli 2003: 9).

As discussed by Mannan (1992a), Metwally (1992), (Yusof and Amin, 2007) and Siddiqi (1992a), the good deeds of the firm support its productivity, efficiency and also good will in the long-run.

Firms perform a duty towards the services of society. According to the Islamic point of view any body who works in a job, providing a utility to society performs a *'farḍ*, i.e., fulfils a compulsory requirement from God. So earning for the livelihood of one's family is appreciated in the Islamic framework.<sup>21</sup> It is also the duty of the firm to spend in the way of Allah (swt) for needy and orphans (4:36 and 2:177).

It should also be noted that sustainable growth requires firms to uphold the CSR at micro and macro levels. While through price and wage policy and the production policy micro level CSR can be achieved, taking into account the larger environment in which the firm works provides an opportunity to achieve CSR at the macro level. Such as providing means for social capacity building and contribution towards income and wealth redistribution in the modern sense provides the firm with Islamic ethical operation norms. Importantly, environmental concern, which is one of the stakeholders in the operation of the firm, is an important aspect of the Islamic moral economy. *Rububiyah* and *tazkiyyah* axioms of the foundational principles of Islamic economic system (Ahmad, 1979 and 1994) require that economic activity or the firm's economic operations should take place in harmony with social environment including natural environment so that exploitation should be overcome and also inter and intra-generational horizontal equity and justice in the use of natural resources should be achieved. *Rububiyah* refers to "divine arrangements for nourishment, sustenance and directing things towards their perfection" (Ahmad, 1979:12), while *tazkiyyah* is "concerned with growth towards perfection through purification of attitudes and relationships" (Ahmad, 1994:20). Thus, utilitarian oriented modern economic growth discourse is rejected by Islamic ethical economy and therefore the Islamic firm is expected to uphold the environmental equilibrium in its operations. It is expected that within this balanced and sustainable environment as defined by Qur'anic principles that the firm's economic activity take place. Importantly, filter mechanisms of the Islamic economic system is endowed with instruments to provide sustainable development through preventing "waste, over-utilization and the excessive exploitation of non-renewable natural resources and the ecological and environmental aspects of moral activity" (Ahmad, 2003: 196), as natural resources and environment is perceived to be *amānah*, or trust from Allah.<sup>22</sup>

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<sup>21</sup> This is observed from the Qur'anic verse: "And Allah hath favoured some of you above others in provision" (16:17); and also from the following *ḥadīth qudsi*: "Trying to earn a lawful livelihood is an obligation in addition to the duties that are obligatory" (Bukhari).

<sup>22</sup> See the compilations of paper by Khalid and O'Brien (1992) on Islamic position on environmental issues.

#### 4.7. Operational Principles of the Islamic Firm

Questions arise about the structural requirements of the firm in the Islamic periphery. These could be described as:

- i) Production of *ḥarām* (prohibited) goods is zero;
- ii) Production of goods satisfying needs is higher and of luxuries is lower,<sup>23</sup>
- iii) Following the Islamic principles, the profit maximization should be moderate.

As mentioned earlier, interest has a negative impact on the productive economic activities. This is evident from the commonly observable fact that when the rate of interest is low, economic activity increases and people are willing to start and expand businesses, which adds positively to the economy. In contrast, when interest rates are high, people tend to be discouraged from making real investment and are more interested in saving that money and earning interest on it. This is not good for the economy, because when a small entrepreneur gets discouraged from borrowing money and starting or expanding his business due to high interest rates, the well being of the society is adversely affected as well (Azid and Asutay, 2007; Yusof and Amin, 2007).

However, in Islamic economics the rate of return on equities, which are not pre-determined, will play its role in the determination of the residuals. In 'boom' days it would be higher than during a period of recession. It varies from project to project. Furthermore, the institution of partnership (*shirākah* or *muḍārabah*) will also accelerate the economic activities of the economy. There is a shared risk. The share in profit is agreed in advance. Projects of trade and production generate an income. The financier may be entitled to a share of this income, but only if he enters into a partnership with the entrepreneur. By entering into a partnership, the financier shares in the risk of the enterprise and by sharing the risk, the lender is directly involved in the enterprise and may receive a share of the profits. This partnership model should be contrasted with the lender as a creditor, in which case

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<sup>23</sup> Chapra (1993:85) classifying the needs and luxuries as: "... 'needs' (including 'comforts') may be used to refer to all those goods and services which fulfil a need or reduce a hardship and thus make a real difference in human well being. The term 'luxuries' may be used to cover all those goods and services which make no real difference in a person's well-being and are wanted mainly for their snob appeal. Everything required for fulfilling needs like capital goods, raw materials, exports, imports, and physical and social infrastructure is 'necessary', while everything that is otherwise, does not fall into this category ... an intricate discussion in the *fiqh* literature about necessities (*darūriyyat*), convenience (*ḥajīyyāt*), and refinements (*tehsīniyyat*). All of these, as defined by the *fuaaha*' (jurists), fall within the range of what we have termed 'needs' above and do not include luxuries or goods which served primarily as symbol of high status. Anything that goes beyond 'needs' has been treated by the *fuqahā*' a prodigality and self-indulgence and has been strongly disapproved".

the lender is not directly involved in the project, and therefore has no right to any share of its profit. The income of the entrepreneur could be characterized as profit and return to capital as profit share (Azid and Asutay, 2007). The same phenomenon is also discussed by Alchian and Demsetz (1972) in the framework of neo-institutional economics.

#### 4.8. Organization of the Resources and Corporate Governance

Islam appreciates the positive role, which firms play in this modern world. Firms organize the factors of production, provide positions for different people with different levels of skill and get rewards according to their efficiency and become assets of the Islamic society. Also, the management of firms provide opportunities to investors to invest their capital in the form of *muḍārabah* and *mushārahah*<sup>24</sup> and get return. Otherwise, in this system, debt is only for the benevolence of the society. The entrepreneur has taken the risk so he has the right to get the reward in return. A significant volume of charity and *zakāh*<sup>25</sup> is expected from this sector, which is also a significant source of distribution of income and sources. Islamic firms do not make but collect money, not producing but distributing the production and through its structure reducing and curbing poverty. The firm avoids too much speculations and uncertainty (Choudhury, *et. al.* 2006; Zaman 1999).

In the Islamic sense a producer must display co-operative and collective economic behaviour with regard to redistribution and resource allocation. There are some altruistic considerations, which may require the firm to produce goods and services, which may not enable it to maximize profits or sale. Pareto optimal condition is not fulfilled in the system where producers are caring for the poor and not for their own profits, given demand is also not acceptable under the umbrella of altruism (Zaman 1999; Kahf 1992b; Bashir 1997). Also, under-utilization of resources is not appreciable; it creates unemployment, which has social consequences as well as depriving the poor. The poorer segment of society should determine the direction of the allocation of resources: for the production of high quality and long durability goods and services (Zaman, 1999).

The underlying motives of the producer should be that s(he) has to earn profit, but as a human being other objectives are also important, such as looking after the interests of others, improvement in the material, moral and aesthetic terms of the

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<sup>24</sup> *Muḍārabah* and *mushārahah* are both Islamic financial modes based on profit and loss-sharing schemes.

<sup>25</sup> *Zakāh* is compulsory alms giving for those people who can afford, which is one of the pillar of Islam indicating the great importance given to social justice.

society, production of the essential goods and services (duty), and provision of employment and as a trustee; motive of profit maximization is not as important.<sup>26</sup>

The organisation of resources, as the discussion indicates, is related to decision-making, which points to the governance issue. Since the decision making involves three fundamental aspects (by whom, for whom and with what resources), governance of the Islamic firm has to respond to these questions in an efficient manner. The corporate governance of the Islamic firm is based on the stewardship theory, which states that decisions of the firm “are taken in the spirit of partnership for the good of the firm” (Lewis, 2005: 14). This is shaped by the Islamic tradition, namely Shari‘ah; and therefore the foundational principles or axioms of Islamic economic system (see Ahmad, 1994 and 2003) have direct consequences on the governance, and hence decision-making of Islamic firm. Lewis (2005:13-21) by endeavouring to respond to the above mentioned three fundamental questions attempted to develop an Islamic corporate governance model. In his model of Islamic corporate governance (2005:19), he states that ‘*shurātic* decision-making process with consultation and consensus-seeking” responds to legal concept of the firm by answering the ‘*decision-making by whom*’ question. The second fundamental question of *decision-making for whom*, which is an economic concept of the firm, is fulfilled by the Islamic regulatory environment such as *hisbah* and the role of *muhtasib*. Regarding the third fundamental question that is *with what resources and to whom* accountability is due, namely the accounting concept of the firm, the institutions of Shari‘ah supervision and religious audit provides the operational framework. Thus, Islamic firm is expected to develop and operate within such a corporate governance framework to fulfil its organisational objectives and its duties to its stakeholders and larger environment in which it operates.

#### 4.9. Identity and Importance of the Employees

Experts have the consensus that the goals of the organization are not only to maximize profit or sales as we mentioned elsewhere, but it is also to create an environment of social justice and especially good relationships between entrepreneur and workers. Literature on sociological economics places emphasis on the sense of identity of the worker within an organization and his attachment to an organization is critical to well-functioning enterprises (Akerlof and Kramtoz, 2005; Granovetter, 2005).

In the above-mentioned state, the organization and workers should behave in a different manner. Then it is a matter of when, where, how and between whom transactions take place. In this scenario, social categories play an important and remarkable role, utility depends on social identity, internal norms guide their

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<sup>26</sup> Qur’ānic verses provide wisdom: “Riches and sons are the adornment of the life of the world, and the righteous works that last are excellent with your Lord in respect of reward and excellent in respect of hope” (18:46).

behaviour. It is admitted in the literature that four components are very important in the structure of any organization: identity, social category, norm and ideal (Akerlof and Kramtoz, 2005; Granovetter, 2005; Walton, 2003).

If workers have their own identity then monetary incentives are complements rather than substitutes. The position of the workers as insiders or outsiders has a remarkable impact on the growth of the firm. In this advanced stage of the economy, most of the firms are investing in by turning the outsider into an insider. Training programs are organized covering themes such as how to avoid ridicule of peers, how to increase the extrinsic and intrinsic motivation, how to enhance self-image and so on (Akerlof and Kramtoz, 2005; Granovetter, 2005; Walton, 2003).<sup>27</sup>

Granovetter (2005) also places emphasis on the network density, where complete information is available and no one is a free rider. He further added that non-economic activity affects the cost and the available techniques of economic activity, i.e., social and ethical embeddings. For example, corruption has a high economic cost whereas; honesty, fairness, reliability and loyalty enhanced the efficiency of the economic agents, the by-product of the social behaviour.<sup>28</sup>

Under the umbrella of Islamic teachings, this aspect has its own particular dimensions. Sociology and psychology have an orientation towards the development of an ethico-moral set-up. It is very significant in the Islamic environment that entrepreneurs/producers are not the owners; they are rather the trustees, the principal source of unity, trust, and, according to the spirit of Islam, they are the brothers and sisters of the workers.<sup>29</sup>

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<sup>27</sup> Pertaining to such considerations, the Qur'ān teaches us in this way: "O you believe! Let not one group scoff at another group; perchance they may be better than they are nor let some women scoff at other women, perchance the latter may be better than they are. And do not traduce one another, nor revile one another by odious appellations; ill is the name of sin after belief. And whosoever will not repent, then those they are wicked" (49:11).

<sup>28</sup> The Qur'ānic wisdom: "Woe to those who are dishonest in weighing and measuring - those who exact a full measure they receive their due from others, but give less than due when they measure or weight for them." (83:1). The *ḥadīth* or the sayings of the Prophet: "Any servant who observes Allah's right and his master's right will get a double reward." (Bukhari); "A servant is a guardian of his master's property and is responsible for it." (Bukhari).

<sup>29</sup> Islamic sources provide principles for this: "For a rich man to crave pretexts to avoid the fulfilment of his commitment towards the basic rights of worker is oppression" (Bukhari); and "Take head of (daily) prayers and of (the rights of) those are subordinate to you" (Ibn Majah); and "Your brethren are your servants whom Allah has made your subordinate. So, the man who has his brother as his subordinate should give him to eat what he himself eats, and to wear he himself. And do not put on them the burden of any labour that may exhaust them. And if you have to put any such burden on them, then help them yourselves (in his work)" (Bukhari).

If a worker has this identity in the organization, then his efficiency is greater than if (s)he has monetary compensation. His/her feelings, as an insider in the organization, have positive impact on efficiency. If it is analyzed in the periphery of Islamic norms it is already available in this system. This has a different setup from the organizational norms. In the environment of brotherhood the scenario will be different, a self-training program is already built in. Another factor, which is very important for workers, is that if firms are not cutting the wage rate, even low pay workers are available and supervision is not considered as loose or tight if that is a symbol and sign of brotherhood (Azid and Asutay, 2006).

Islam promotes a universal approach that considers all human beings as a single brotherhood, and encourages peace, tranquillity and the welfare of all. Islam enjoins justice and fairness in all human dealings. It places a high value on individual freedom and human dignity. In addition, Islam grants certain inalienable rights to individuals. These fundamental human rights include: the right to life, the right to equality before the law, the right to privacy, the right to protest, the right to justice and the right to participate (Ahmad, 2000).<sup>30</sup>

Muslim producers should be concerned with the malnourishment, reduction in life expectations, and other biological and medical conditions of their workers as well as other members of the society. This is another aspect of the identity of the workers in the Islamic system that provides a pleasant and honourable environment to the workers and makes them proud when they show their attachment with the firm that has this behaviour.

In resultant, with the creation of more jobs in this environment even with low wage rates, if the focal point is the identity of the workers and their feelings about themselves as insiders, that will ultimately make them more productive and efficient. It implies a large scale of output and lower level of prices.

In the teachings of Islam, capital is for the services of human beings, whereas in practice the reverse is true, and labour takes priority over capital. Muslim scholars interpreted the importance of labour in different ways. Human beings who are productive and are useful to mankind, obtain the right of being one of the representatives of God on the earth, since he believes in Islam (Qureshi, 1959; Tabakoglu, 1983; Khan, 1969; Azid 2005 and many others). All things are created to satisfy the materialistic needs of human beings (Tabakoglu, 1983). Islam assigns great value to an individual's productive power: labour (Khan, 1969; Tabakoglu, 1983; Qureshi, 1959 and 1960; Sultan, 1992 and many others). The fact that work alters production has a significant value as *'Ibādah* or worshipping God (Tabakoglu, 1983; Khan, 1969). Working is an Islamic obligation for an individual as well as from a social perspective (Tabakoglu, 1983; Khan, 1969). As a human

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<sup>30</sup> The Prophet said: 'All people are the dependent of Allah, and the most beloved among them are those who are most benevolent to his dependents including those who put his resources to proper use (Ibn Kathir, 1980:287).

being labour is considered as an independent factor of production. The working environment must be humane, free from any type of exploitation and pressure (Tabakoglu, 1983 and Khan, 1969). The worker, therefore, cannot be forced or allowed to work under unhygienic conditions (Khan, 1969; Qureshi, 1959 and 1960).

#### 4.10. Contextuality

Relational exchange theory indicates that relationship duration facilitates in developing relational norms i.e., verbal and non-verbal credible commitments, supporting a balanced governance mechanism between exchange partners. Ring and Van de Ven (1994) explained that relationship duration could affect inter-firm governance or inter-organizational relationships (IORs). Business partners marginalized these relational hindrances through relational norms, formal and informal contracts and trust. Business relationship duration also encourages business partners to consolidate the antecedents for relationship duration. Current empirical work shows that relational governance is associated with trust and that it improves the performance of inter-organizational exchange (Heide and John, 1990).

The degree of contextuality plays a major role in the performance of business relations. In fact, it is the basic norm of the business sector that the language of managers should be relatively simple, straightforward statements and based on truth. If greed, cheating and stealing are part of the language of managers, then these firms will not get success and will not have any credibility in the market. So, Islam strictly ordered its followers whenever you say something to say it in a straight way.<sup>31</sup>

Language reflects the bond with each other; abusive language weakens the liar's behaviour and this will create other sorts of unethical behaviour in the market<sup>32</sup> and the Qur'ān also warns those who are not behaving in a good manner with others.<sup>33</sup>

In this system, to fulfil a promise is an obligatory condition.<sup>34</sup> If the dealing of the management is fair and it is based on ethical and moral norms, then a greater part of society will get the benefit, which will ultimately enhance the efficiency of

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<sup>31</sup> As it is observed from the following verses of Qur'ān: "O you who believe! Fear Allah, and speak a straight speech" (33:70), and "O Believers! Why do you say what you do not act? Most odious it is to Allah that you should say what you do not act" (61:2-3).

<sup>32</sup> God says about the liars in Qur'ān as: "Allah does not approve of the uttering of harsh words, except by one who has been wronged; and Allah is ever, Hearing, and knowing" (4:148).

<sup>33</sup> Qur'ān: "Nor revile one another by odious appellations" (49:11).

<sup>34</sup> "O you who believe! Fulfil your obligations" (Qur'ān, 5:1); saying of Prophet describing in this way: "There are distinguishing features of a *munāfiq*, when he speaks, he lies, when he promise he backs out, and when he given something in trust, he breaches the trust" (Bukhari).

the economy and society in the long-run. It is common in commerce that trust is a language-based phenomenon. It is observed even in the conventional system that behaviour which shows mere self-interest, suspicion, greediness, immorality and cutthroat tactics are not promoting the image of the firm. As we have discussed above, an entrepreneur is considered as a person of ideas, an economic innovator and a provider of capital and someone who takes the task for the welfare of society. The entrepreneur should also apply fair rules for buyers as well as sellers. Simultaneously business ethics are considered as an item of added value. Trade in Islam is considered as a sacred profession and according to one saying of the Prophet, God has given 90% share to this profession and 10% to the rest of the professions. It means that we cannot find the world of business separate from the world of faith.

#### **4.11. Determination of Prices**

Prices tend to be personal and human in nature. Prices may be positive, negative or zero. There is no scope for a price system based on the market mechanism, a market mechanism supplemented by conscious control, supervision and cooperation. For the determination of prices, there is a need for institutional reforms and structural change. Some economists suggest that prices will be according to the average cost. Muslim economists have the consensus that there should be guided cooperative prices; administered prices of goods and services are limited to the basic human needs. There should be direct supervision and control on the prices.<sup>35</sup>

#### **4.12. Market Structure**

Market structure should be for the welfare of society, whatever formulation is prevailing in the industry. As Siddiqi (1992b) explains, once the monopolists abandon the immoral policies they used to follow in suppressing competition, the industry would automatically become competitive in most cases. About oligopoly, he said that if oligopolists cooperate with each other for the good of the society and they have a joint venture for technical research and the elimination of competitive advertisement, this will be a healthy cooperation. However, there should be no price discrimination and no exploitation of power. There should be equity and fairness. An optimal mix of supervised competition and induced voluntary cooperation may provide a better basis for Islamic economic analysis.

#### **4.13. Advertisement**

An Islamic firm may well advertise to inform potential buyers of their existence. Since buyers and sellers change over time, since information is forgotten, since new producers appear, the existence of sellers must be advertised. However, advertising should be informative and educational, excessive advertising is not allowed because this will be a cause of wastage and misallocation of the

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<sup>35</sup> For detail of price determination, see Bashar (1997).

resources. Failure to provide a free flow of information creates market frictions and raises doubts, so minimize the information gap. As we know the total cost of placing a product on the market should actually be broken into two parts – total production cost and total selling cost. Metwally (1992) states that good deeds, i.e., moderate profit and spending on philanthropy, have a positive impact on the price of the output of firms but it is certainly not a substitute for advertising. Alchian and Demsetz (1972:778) discussed as: “Reputation, i.e., credibility, is an asset, which is another way of saying that reliable information about the expected performance is both a costly and a valuable good. The reason again is that a reputation for “honest” dealings – i.e., for actions similar to those that would probably have been reached had the contract provided this contingency – is wealth”. Nevertheless, there is no place for deceptive advertisements. Public opinion about the reputation of the firm enhances the efficiency (with less selling cost) and sale of the firm, which will consequently cause profits to rise. In many instances, the goodwill of the firm, if it really exists (based on the good deeds of the management), will create profit that will last for long periods of time and shift the demand curve towards the right. Maybe this will increase profit, which is in excess of a normal return on investment. However, because the management is working in the ethical and moral environment, in this situation, excess profit can be transferred to the other stakeholders, either by reducing the price, increasing the wage rate or spending on projects for the welfare of the community.

In the conventional system the consumers are forced to pay the cost of advertising without their consent, as it is not necessary that every piece of information is provided to them. However, advertising also has a positive impact on economic activities. It is believed in conventional economics, that the good reputation of the firm has a negative impact on its cost of advertising. The cost of advertising in the Islamic economy must be less than in the conventional system.

#### **4.14. Cost Structure**

The cost structure is related to the operation of the firm, which is determined also by the ethical economy of the Islamic tradition. In looking at the conventional literature, Coase (1998:73) states that “the costs of exchange depend on the institutions of a country: its legal system, its political system, its social system, its educational system, its cultural and so on”. In the Islamic framework different scholars have different views. For example, Amin and Yusof (1997) have discussed the opportunity cost in the premises of Islam. According to them, the concept of opportunity cost is related to the nature of the goods; goods are either necessities or they are luxuries. They derived the opportunity cost structures for the necessities or luxuries for the Islamic firm. It means that economic factors subordinated to overall ethical and moral values. Opportunity cost of *ḥarām* (which are forbidden) goods is very high. There are taxes on refinements and subsidies to necessities. Mannan (1992d) states that the Islamic firm is not too commercialized so with a smaller cost structure the output of the firm is expected to be larger

because this firm is working in a debt free economy (no interest payment) and equity is the basic instrument. As a result of good deeds (charity, spending in the way of God) more demand will be created and goods will be at a higher price, relative to the secular firms with a similar cost (Metwally, 1992). Alchian and Demsetz (1972) emphasized on the mutual confidence and claimed that monitoring cost will be zero in this environment. In a nutshell, the choice of production technique should not be made on the narrow grounds of economic and technical efficiency associated with the production of a particular output at a minimum cost. The average cost comparative to a conventional firm should be lower because of different variables, such as efficient information environment, identity of the workers, relationship between employers and employees, no fixed cost of capital, mostly joint ventures between the supplier of capital and supply of labour. In this scenario the reward of labour is according to the profit so there is no problem of the fixation of wages, opportunity cost of the products, low costs on training and advertising. However, the increase in costs due to welfare expenditures spending may be offset by the reduction in the average cost of the firm.

## 5. CONCLUSIONS

The teachings of Islam related to the business organization are more than those we have discussed here. In the Islamic economics framework, the main epistemological source and methodology is based on Islamic injunctions instead of the economic rationale, as the individual is not considered as a commodity but as a 'human being'. Consequently, social welfare, the role of the workers in the firm and their rights are well protected and their participation and cooperation in the production process is appreciated on a large scale. All of the factors of production such as capital, technology and money are for the service of human beings and the reverse is not true. The objective of the firm is to earn profit for its shareholders, look after the interests of its employees, protect the rights and interests of its consumers, and provide them with quality products at just prices. This is not a free market economy; the role of the state where it is necessary is recommended. It is the duty of the state to look after the benefit of consumers, workers and the society as a whole. Perhaps in the conventional system, resources are allocated efficiently but not necessarily equitably. There is a need for some regulation, which will decrease the degree of moral externality. The entrepreneurs need not withdraw themselves from the world of business but should undertake moral training to increase the moral, ethical and social values of the society, which in the long-run will increase the overall productivity of the economy. In return, it is the duty of the workers and the managers to look after the interests of the entrepreneur.

In fact, this system trains its followers in having a sense of responsibility for the well being of all. In a nutshell, the responsibility of the management in this system is to increase the general prosperity and service of the society's well being. It is the duty of the state to restructure the production priorities and then recreate the demand of the society. The teachings of Islam give its followers a major challenge

and those who accept it will get success in this life as well as in the life hereafter. The fact of the matter is that we cannot tame markets with the cane of legislation. Hence, firms cannot be forced to act morally in such a market. We need to transform the market into an ethicized market by means of endogenizing the moral element in all of the socioeconomic menus, preferences, institutions and interactions. Such a firm is described as a cooperative-competitive organization. It is cooperative in being participatory and complementary following the generic essence of the Unification Epistemology. It is competitive in the sense of excelling in these functions as they are found to be the sources of productivity, efficiency, market transformation and social well being reinforcing the total strengths once again. Thus, competition when applied to gain excelling levels of complementarities, cooperation and sharing of resources (*muḍārabah-mushārah*) must logically at once complement the attribute of cooperation. In this sense, competition-cooperation is a complementary concept on the moral plane.

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