

## **STAKEHOLDERS MODEL OF GOVERNANCE IN ISLAMIC ECONOMIC SYSTEM**

**COMMENTS: MUHAMMAD UMER CHAPRA\***

The main thrust of this valuable paper written by two highly qualified and respected scholars is that “the stakeholder theory of corporate governance finds strong roots in the Islamic economic system”. This leads the authors to argue that all stakeholders should participate in corporate decisions; that managers have a fiduciary duty to serve the interests of all stakeholders; and that the objective of the firm ought to be promotion of the interests of all stakeholders rather than those of just the shareholders. The paper then discusses property rights and contractual obligations in Islam and the rules of behavior prescribed by Islam to ensure that these rights and obligations are duly honored.

While the paper’s overall conclusion in favor of the stakeholders’ model and the scholarly manner in which it is arrived at are highly commendable, the paper stops far short of reaching the desired end. What is crucial is not just the defense of stakeholders’ rights, because the Franco German model does the same<sup>1</sup> and some Muslim scholars have also defended these rights,<sup>2</sup> but rather to show how to ensure that these rights are protected. Here the authors rightly emphasize the role of rules of behavior or what are now referred to as institutions in Institutional Economics. This leads the reader to the more complex question of how these rules can be enforced. Here the authors have taken an easy way out by assuming that “in an Islamic system, the observance of rules of behavior guarantee internalization of stakeholder rights (including those of the society at large). No other institutional structure is needed”. This is where, I think, the principal weakness of the paper lies.

While the internalization of Islamic rules of behavior would help protect stakeholders’ rights, it is not necessary that these rules would become automatically internalized. The stark reality is that, while Islamic norms had become internalized in the Muslim society in the Classical period of Islamic history, they are no longer so. The question is: why? What is it that led to the

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<sup>1</sup> Macey and O’hara (2001), pp. 1 and 5.

<sup>2</sup> Chapra & Ahmed (2002).

internalization of rules of behavior in the Classical period and has led to their general violation in modern times?

The answer lies in incentives and deterrents. Rules of behavior get observed only if incentives and deterrents operate effectively in a society. While this happened during the Classical period, it is not happening now. Islam has provided two sets of incentives and deterrents. One of these is reward and punishment in this world and the other is reward and punishment in the Hereafter. While the reward and punishment in this world are missing because of the non-existence of an enabling educational, socio-economic, political, legal and judicial environment, the belief in accountability before the Almighty in the Hereafter has also become weak.

A number of factors have dented the operation of incentives and deterrents in modern times. The first of these is substantial erosion of the conscientious religious environment which prevailed during the Classical period. This has weakened self-enforcement of norms by individuals. Secondly, there prevailed in the Classical period what Ibn Khaldun calls '*asabiyyah*' or social solidarity. Anyone who tried to violate the society's norms became ostracized. This ensured honesty and fairness in mutual dealings and acted as an informal contract enforcement mechanism. Thirdly, the market system worked more effectively because the firms operating in the market were generally small, being individual proprietorships and partnerships. Separation of ownership and control did not, therefore, exist and the principal/agent problem was not serious. Moreover, competition was tougher as a result of the small size of firms and their large number. Market discipline, therefore, played an important role in the effective enforcement of the rules of behavior. Fourthly, what helped was the independence, honesty and promptness of the judicial system. Courts as well as *muhtasibs* (ombudsmen) ensured that property rights were honored and contractual obligations were honestly fulfilled.<sup>3</sup> Lastly, honest, conscientious and legitimate governments ensured the observance of the society's rules of behavior by all, irrespective of their position in the society or the power hierarchy. Therefore, it was not just the rules of behavior given by Islam, but also the socio-economic and political environment which led to the enforcement of property rights and contractual obligations.

Such an environment does not exist any more. As a result of the socio-economic and political decline in the Muslim world, the family, the society, the courts and the government, which are crucial elements of a proper enabling environment, do not play their roles effectively in the enforcement of values. The effective operation of incentives and deterrents has, therefore, become weak. The rules are still there but they do not get enforced. Observance of these rules starts in the family with the proper upbringing of children. Unfortunately, a majority of parents,

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<sup>3</sup> For a more detailed discussion of these factors see, Chapra and Ahmed (2002), pp.2-7.

and in particular mothers, are not well educated in Islamic norms. Institutional arrangements needed for such education are also grossly inadequate. The stress in religious education also seems to be, unfortunately, more on appearances and trivialities than on the uplift of character. This has been one of the primary factors which have contributed to an increase in the violation of Islamic norms. Those who violate the norms do not only not get socially ostracized, but are rather able to get prestige. The persistence of these violations over a long period has led to their being locked-in in Muslim societies through the operation of path dependence and self-reinforcing mechanisms. Courts have also become corrupt and governments are generally illegitimate and not accountable before the people. It is, therefore, crucially important to change the environment so that everyone is clear about what the norms are and those who violate them do not only feel the pinch materially but also get socially ostracized. This would reduce the principal/agent conflict of interest by inducing individuals to do what is right and to abstain from doing what is wrong. Without a change in environment and social, political and judicial support, moral as well as legal norms are not likely to be effective.

Without the effective operation of incentives and deterrents even market discipline will tend to be weak. Well-functioning competitive markets are indispensable for effective market discipline as well as the protection of stakeholders' rights. It is competition which punishes those who cheat in quality and quantity, do not give satisfactory dividends, and do not in general promote the interest of the society. However, this is not happening because of a weak competitive environment.

It is also necessary to have a proper legal framework for the protection of stakeholders and its effective enforcement.<sup>4</sup> Countries with properly regulated markets have higher growth and are also less prone to economic crises.<sup>5</sup> Consequently legal protection has become an important variable of policy in most countries during the 1990s.

Legal protection may, however, be ineffective unless reinforced by independent, honest and efficient courts to promptly redress the grievances of stakeholders. It is also necessary to have effective internal controls, proper accounting, independent audit, and adequate transparency, to reduce the opportunity for managers and directors to serve their vested interests. In spite of all these measures protection of stakeholders' right would tend to be weak if they are themselves unable to have a say in corporate decisions. The authors have rightly recognized this point. There is, however, no discussion in the paper of how to make it possible for the diverse stakeholders to have a say in corporate decision making.

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<sup>4</sup> See Chapra and Ahmed (2002); see also Chapra and Khan (2000).

<sup>5</sup> La Porta, et. al (1999).

All this does not deny the importance of moral values or rules of behavior on which the authors have rightly laid great emphasis. The existence of legal and institutional protection and stakeholder participation in decision making, though necessary, will not be sufficient. There are so many clandestine ways of depriving stakeholders of their rights that both market forces and legal protection may be ineffective unless there is an inner urge on the part of agents themselves to fulfill their commitments faithfully. In societies where there is no conflict between moral norms and social behavior patterns, moral norms as well as laws get enforced because, as Cooter has rightly put it, “officials lack the information and motivation to enforce the law effectively on their own”.<sup>6</sup> Legal protection tends to be ignored when the law is inconsistent with ‘actually prevailing’ moral and social behavior pattern. Consistency between moral and social norms and actual behavior is considered to be indispensable ‘social capital’.

Such social capital does not seem to be adequate in Muslim countries.<sup>7</sup> Therefore, new laws will not by themselves be able to provide the necessary protection to stakeholders. Hence, while streamlining legal protection for stakeholders, we should bear in mind the stark reality that, in the last analysis, it may not be possible to ensure the honest and fair fulfillment of property rights and contracts without the help of moral values and their implementation through an enabling socioeconomic environment and impartial judiciary.

Within the framework of Ibn Khaldun’s analysis of the rise and fall of civilizations, moral norms, which emanate in his analysis from the *shari’ah* in a Muslim society, may not get reflected in laws, and the laws may not get implemented effectively if the political authority does not attend to this task.<sup>8</sup> It is the responsibility of the political authority to check all morally objectionable behavior – dishonesty, fraud and unfairness – that is harmful for socio-economic development. It must also ensure the fulfillment of contracts and respect of property rights, and inculcate in the people qualities that are necessary for safeguarding the interests of all stakeholders.<sup>9</sup> The governments generally fail to perform these tasks if they are not accountable before the people, do not apply the law equally and equitably on all the different strata of the population, and do not

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<sup>6</sup> Cooter (1997), p.191.

<sup>7</sup> For a valuable discussion of social capital, see Dasgupta and Serageldin (1999).

<sup>8</sup> Ibn Khaldun, *Muqaddimah*, pp.190-91.

<sup>9</sup> It is only recently that the political dimension of economic reform and development has started to receive analytical attention. Douglas North emphasized that the only way economies can develop optimally is to keep ‘nasty’ behavior in check. Governments are capable of doing this. If they do not, individuals may behave in ways that could undermine the very foundation of the system and lead to social chaos and economic collapse (See the Chapter, “Ideology and the Free Rider”, in North, 1981). John Williamson has also focused on the political context of successful economic reform by analyzing 11 developed and developing countries [See Williamson (1993)].

employ staff on the basis of character and competence.<sup>10</sup>

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<sup>10</sup> Ibn Khaldun has devoted to this question a whole chapter entitled "Human Development Requires Political Leadership for its Proper Ordering" in addition to substantial discussion in several other chapters. See his *Muqaddimah*, pp.235-43.