CHAPTER – III
THEORETICAL FRAME WORK
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THEORETICAL FRAMEWORK

This chapter has been divided into four sections. Section one deals with Foundations of Islamic Economic Theory. Section two deals with Methodological Approach to Islamic Economics, Its Philosophy, Theoretical Construction and Applicability. Section three deals with Fiqh Foundations of the Theory of Islamic Economics, Section Four deals with analytical tools of Islamic Economics: A Modified Marginalist Approach, Section Five deals with portfolio choice and asset pricing in Islamic Economics.

Section I

3.1 Foundations of Islamic Economic Theory

The foundation of Islamic Economic Theory is derived from the basic source of knowledge on Qur’an, Sunnah (Al Hadees), Ijmah and Quiyas. The last two are commonly known as Ijithihad.

3.1.1 Qur’an: Qur’an contains general and broad guidelines for the conduct of human beings. On economic matters too, it provides a set of fundamental principles to guide human conduct. Waqar Hussains (1920) in ‘Economics in the Qur’an’ has
reported over 1400 verses on economics out of 6666 verses in the Qur’an. Consistent with these principles, and guidelines the superstructure of the economy has to be built in each age, according to the particular circumstances of each age. The injunctions of the Qur’an are immutable and applicable to all societies and are valid for all times to come. Qur’an is thus the primary source of Islamic Economics.

3.1.2 Sunnah of the Prophet Tradition (Peace be upon Him):- Sunnah is the speech, action and tacit approval of the prophet (( Peace be upon Him) as recorded in the books of traditions have analyzed classified and interpreted the whole material. It covers the entire orbit of life, including the economic aspect. Knowledge of the traditions containing injunctions about economic activities is an essential part of the training of Muslim economists.

Qur’an directs to follow the exemplary conduct of the prophet. The Qur’an says “And whatsoever the apostle give to you, take and whatsoever he forbade to you, refrain from.”

3.1.3 Ijmah (The consensus of Opinion):- It refers to the Consensus either of the community or of the Muslim jurists. It is a principle of new legal content that emerge as a result of exercising reason and logic in the fact of rapidly expanding society and human activity such as the early Islamic one, begins with the companions and extended to subsequent generations. Then exist a vast literature developed by Muslim Journist over the last 14 centauries. It deals with the formalizations of the
injunctions of the Qur’an and the traditions of the prophet. The jurist have been elaborating and deriving inferences about economic questions as well.

The prophet is reported to say “My people shall never agree on the error”. It means that those people who are men of understanding shall only agree on the right way and truth.

3.1.4 The Qiyas :- All the School of jurisprudence (Shafi, Hanafi, Hambali, Maliki) agreed that, in matters which have not been provided to by a Qur’an or sunnah text, not determined by a consensus of opinion the law may be deduced from what has been laid down by any of these three authorities by the use of Qiyas (Abdul Rahman, Mh. P. 138) It means measuring by comparing with or judging by comparing with a thing (Muhammed Ali, the religion of Islam page 104)

Knowledge on the fundamental sources of Islamic Economic Theory (Qur’an, Hadhis, Ijmah, Qiyas) is the nucleus of Islamic Economic methodology. The nucleus contains some knowledge relevant to every discipline. Knowledge in the nucleus pertaining to economic behavior of individuals, families communities and society can be collected to form an “economic corpus” A ‘corpus’ is a collection of extractions from Qur’an, Hadhis, Ijmah and Qiyas relevant for a particular field of enquiry, including politics, sociology, law, business and economics. Derivation of corpuses from the nucleus is shown in figure no. 3.1
The corpus containing Islamically valid assumption, institutions precepts and postulates related to the economic behavior of individuals and communities is extracted from nucleus. Islamic economists are required to use their intellectual, analytical and empirical skills to develop knowledge around the economic corpus without violating the conditions in the nucleus.

The economists may revive the highly sophisticated methodology of traditional scholars such as, Shatibi (R), Ibin - Kalden (R), Abu Hamid Al Gazali (R) or may select promising western economic models and theories and use them within
an Islamic paradiagram. The characteristics of the components must be compared with the elements of the economic corpus and the nucleus. The components of the selected theory may be classified into three categories. Islamic, neutral and unislamic. The components conforming to the principles, hypothesis and assumption contained in the corpus are classified as Islamic.

Those having universal application are considered as neutral vis a vis Islamic thought. The neutral components can be validated for inclusion in Islamic Economic Theory. Components which conflict with Islamic thought must be discarded because they are UN Islamic in character. The two parts Islamic and neutral must be put together into a complete model, filling the gaps due to unislamic theory by replacing with the new element on the basis of ijithihad. For eg:- If interest is discarded from a modern economic theory, a valid substitute such as profit- Share, can be plugged in as a substitute for interest to complete the model. This is renovated model may be implemented in an Islamic Economic System. This approach to the Islamization is illustrated in figure no. 3.2

In nutshell, Islamization represents a combination of

(1) A nucleus including an appropriate corpus from the Qur’an and Alhadith for each discipline

(2) The accommodation of functionally Islamic as well as neutral assumptions, postulates and principles from the existing non Islamic literature and

(3) The addition of new thoughts consistent with the corpus developed on the basis of Ijithihad
Various aspects of the forgoing approach for the theoretical framework of Islamic Economic can be studied from the explanations of Abdul Hamid Abu Sulaiman and Ali A Yousuf.
3.2 Secondary Sources

There are two secondary Sources in Islamic Economic

a) History of Muslim

b) Real Life Data

a) History of the Muslim: - It contains much scattered material about the economic life of the peoples. These parts of the history serve as useful precedents for the present day economy.

b) Real life data: - This is the main area of operation for a Muslim economist. He studies the real life conditions and behaviour of the people and uses the available data for analysis and formulation of policies. The real life data here refers to the objective conditions prevailing in an economy.

3.3 Foundations of Islamic Economic Theory under Holistic Economic Approach

The Islamic Economists developed their analysis by employing reason and real life data to the divinely ordained content of Islam. Islamic Economy cannot be conceived outside this basic frame work. Islamic Economic conceives human behaviour in its totality. It treats human life as a compact whole which is composed of multiple - mutually reinforcing subsystems. It affects the human behaviour only from the periphery. The hardcore of the system is composed of the basic believes in
the unity of God, in the apostle hood of Muhammad (Peace be upon Him) and man’s accountability on the Day of Judgment. These beliefs are the foundation of each sub system (Xiauddin Sardar 1976 and Munawar Ahamed Anees 1975 Lahore)

The hard core radiates the fundamental principles of behavior and moulds human attitude in all the sub systems. Between themselves the subsystems are opened and interacted. But each sub system also has a composition of its own which aims at the achievement of ‘falal’. The economic sub systems consist of legal foundations of justice (adl) and ethical foundation of moderation (iqtisad) and benevolence (Ihsan). The legal foundation ordains legal and contractual relationships. Although Islam has a mature and comprehensive legal system, yet the total area of human behaviour covered by the legal injections is rather small. A very wide area of human behaviour consists of voluntary acts. The voluntary acts are influence by consideration of moderation and benevolence. Moderation is the mother - norm and governs individual behaviour towards one’s own self. Benevolence is a cluster of ethical precepts and influences inter personal relationships. Figure no. 3.3 below illustrates the holistic vision of human behaviour and the place of the economic sub - system in it.

Islamic Economic takes into account the economic behavior of man in all the context of his overall conduct. It does not restrict itself to the ‘market’ variables; instead, it integrates the findings of other social sciences into its subject matter.
Secondly a very high content of Islamic Economic is normative. The Islamic Economists have the obligation to discharge the Qur’anic duty of enjoying what is proper and forbidding what is improper.

Thirdly, despite being highly normative, Islamic economics has a vast positive content as well. It attempts to study the impact and reaction of various legal
injections and ethical values on the economic variables. For eg:- it may be of interest to study the effect of prohibition of interest on the level of savings, investment and employment.

Fourthly Islamic Economic can also make use of the tools of analysis developed by modern Economics, Math’s, Statistics, Operation research etc.

3.4 General Theory of Islamic Economy

M. Ariff (1985) in his “Towards the Shariah Paradigm of Islamic Economics beginning of scientific revolution V. A. (2:1) PP 79.99 and Mohammed Akram Ghan. An introduction to Islamic Economic (1999) formulated a general Theory of Islamic Economics as a theory of transition to Islamic Economic. Figure No. 3.4 will illustrate the points.

Dr. Ariff is of the opinion that following the strict regulations of Shureea, the analysis of existing public policies, and empowering the awareness of existing social realities can be framed for the formulation of new theoretical foundation in Islamic Economics by means of utilizing available social and Educational institutions. As a result we can frame new hypotheses to take the challenges of the changing scenario. This endeavor will help for the formation of Transition theories under shereath regulations which is suitable to support not only the Islamic society but the society as a whole.
**Figure No. 3.4**

**General Theory of Islamic Economy**

Section II

3.5 Methodological Approach to Islamic Economics- Its Philosophy and Applicability.

3.6 Scientific Theory Formation in Islamic Economics.

According to Ekelunt and R.B Herbert (1990), scientific theory in the field of economics (and in the other fields of science) is formed from three basic constituents:

(1) Definitions or Terminologies
(2) Postulates/Axioms/Assumptions
(3) The Hypothesis.

3.6.1 Definitions or Terminologies

It should be emphasized that the understanding of any theory, its consequences and usage will always depend on various definitions introduced by Economists having resulting characters.

a) Mohammed Akram Ghan (1999) in his “An introduction to Islamic Economics” gives a definition which emphasize the comprehensive character of the subject based on the universal moral values of Islam. According to him “Islamic Economics is a
science aims at the study of human ‘falah’ achieved by organizing the resources of the earth on the basis of co-operation and participation”

The key concepts in the above definition are the following:

a) Falah
b) Resources ; and
c) Cooperation and Participation

a) Falah

It is difficult to find a single equivalent for this term in the English language. The term falah has been derived from the Arabic root flh. Its verbal form aflah, yuflihu means: to thrive; to become happy; to have good luck or success; to be successful. According to Raghib at - isfahani, falah is a both-worldly concept. For the life in this world, it represents three things; baqa (survival), Ghana (freedom from want) and izz (power and honour). In the hereafter, it stands for: baqa’ bila fana (eternal survival), Ghana, bila, faqr (eternal prosperity) izz, bila, dhull (everlasting glory) and ilm, bila, jahl (knowledge free of all ignorance). According to Qur’an the ultimate goal of human life should be the achievement of falah in the year after.

Although the ultimate object of Islamic economics is the achievement of falah in the life to come, but it would be reward for one’s deeds during his stay in this world.
In the context of this worldly life, falah is a multi-dimensional concept. It has implications both for individual behavior (micro-level) as well as for collective behaviour (macro-level).

### 3.6.2 Conditions of Falah

The conditions of falah may be categorized as below:

1) Spiritual
2) Economic
3) Cultural, and
4) Political

#### 3.6.2.1 Economic Conditions of Falah

**Infaq:** Infaq refers to spending on others and on the social needs of the community. This is something distinct from social alms or charity, which have been prevalent in all civilized societies. Islam has broadened the concept of charity in a number of ways. First, it has made obligatory a bare minimum of social spending (called zakath) on all those who have a surplus over and above their needs. To that extent, it is not voluntary. Second, in its broader meaning, infaq covers expenditure on one’s own family as well which is not so in the case of charity. Third, Islam recognizes the right of the poor and the needy to receive a share from the wealth of the rich.
poor do not owe any obligation, moral or social, towards those who spend something on them.

Fourth, infaq has to be purely for the sake of God who has promised reward in the hereafter. Charity in a secular society is usually done for winning social approbation rather than to seek God’s pleasure. Infaq in the Islamic sense is a mechanism to nourish one’s spirituality.

However in economic theory the importance of infaq is that it is a good form of transfer payment system that enables to the consumption demand of lower income group who’s MPC is near to one. Consequently demand for Investment increases leading to easy capital formation and removal of depression. Zakah is part of the broader concept of infaq.

**Prohibition of Interest:** The Qur’an declares interest on loan capital (riba) as a hindrance to the achievement of falah. The wealthy exploited the poor and the needy. The Prophet (peace be upon him) declared all forms of interest as unlawful. He took various preventive measures as well so as to forestall the infiltration of interest into the economy in disguised forms.

The main point that has been emphasized is that interest is a potent means for perpetrating exploitation and inequity. The road to falah would remain blocked until interest is completely eliminated from the economy.
**Fulfillment of Covenants and Trusts:** Fulfillment of covenants and trusts is a necessary condition for falah. In its simple meaning it stands for honouring personal commitments and promises. But some scholars have placed a broader interpretation on the Qur’anic teaching of fulfilling covenants. According to them, it involves meeting all one’s social and religious obligations.

One also has obligations towards the family, neighbours and the society. From this they argue that polluting the environment through industrial waste contravenes one’s obligations towards the society and hence retards the social pace towards falah. Similarly, the government has the obligation to ensure welfare of the people. The society cannot achieve falah until its inhabitants fulfill these implicit covenants.

**Justice:** The Qur’an has pleaded for justice at a number of places. It has linked falah with the observance of justice in all affairs. The Qur’an uses the term zulm (inequity) as an antonym of justice. The Qur’an repeats that the zalim (one who perpetrates zulm) would not achieve falah. A society in which one’s lawfully acquired wealth is appropriated by others without any compensation of consideration would suffer from wide inequalities. Islamic law has clearly defined the lawful means of acquiring wealth. Digression from these means would amount to zulm and would hinder the way to falah. Enterprise: God speaks of enterprise and struggle for livelihood as “seeking His bounty”. Enterprise and effort to harness natural resources are an essential condition to achieve falah. The Qur’an says: “And when the prayer ends disperse freely on earth and seek to obtain (something) of God’s bounty, but
remember God often, so that you might attain falah” (62:10). Thus the productive economic activity contributes to the falah of the society as well as of the individual.

In brief, falah is a multi-dimensional concept. It covers the whole life of an individual and all aspects of a society. Its different conditions reinforce and supplement each other. Establishing a socio-economic institutional framework facilitates its achievement and it is the main concept of theory formation in Islamic Economics.

3.7 Resources

The second key concept in the definition of Islamic economics is “resources” of the earth. God has created these resources for all human beings and has made man their trustee. God would like man to use these resources to achieve falah. Islamic economics studies human behaviour towards these resources and investigates those modes of their development and use which lead to falah. Since man is not the real owner of these resources he is not independent in deriving benefit from them. The resources of the earth are meant to provide livelihood to the creatures of God. Therefore, no one should block these resources, depriving his own self as well as others of their use. The overall spirit of Islam is that either one should use the resources one has comes to possess or release them for others.

The Qur’an informs us that God has created sufficient resources for His creatures. Therefore, the apparent scarcity of resources may be either due to their
improper use or imbalanced distribution. Islamic economics studies resources from the point of view of ‘adequacy’ rather than scarcity. Therefore, if some degree of ‘scarcity’ is being encountered, ways and means should be found to restore the natural state of adequacy. This could probably be achieved by broadening the productive base, improving technical know-how, re-distributing the resources or curtailing human wants. Scarcity of resources is a man-made situation and Islamic economics explores the ways and means to rectify it.

3.8 Cooperation and Participation

Islam emphasizes cooperation among human beings. Co-operation, from an Islamic viewpoint, appears more in line with the broader cosmic phenomenon of the entire universe. Nature makes a magnificent display of harmony and cooperation.

Human beings are conceived to be like the organs of a body, so that the whole body should sense pain if any organ suffers from discomfort. Islamic social norms prescribe a high level of personal sacrifice for others and cooperation among them in all economic needs.

It was this spirit of ‘participation’ that the Prophet (peace be upon him) tried to inculcate when he exhorted people to share their surplus food, housing, mount and land with others. He praised the tribe of Ash’ar because they used to pool their foodstuff and distribute them in times of food shortages. His decision to distribute
the funds of fay’ and poll-tax among the people is also an indication of the Prophet’s strong preference for ‘participation’ of the people in the resources.

According to Yousuf Ibrahim professor of Islamic Economic, Qatar University. Islamic Economics is science studying the guidance of human behaviour towards the use of resources for satisfy the needs of the people by means of logical production and distribution for consumption.

This definition helps the theoretical foundation of Islamic Economics in the following grounds

a. The resources are enough for satisfying the needs
b. The resources should be protected from waste
c. The human behaviour towards the resources should be controlled by divine injections
d. Only legal needs, needs that build life on earth should be satisfied
e. Illegal needs (desires), which destroy life on earth, should not be satisfied, they are never ending and never satisfied.

Islamic Economic system, a normative economic system, has been built up on certain fundamental Islamic philosophies. According to Qur-anic teachings real and absolute ownership of wealth belongs to the creator of the same, Almighty God Qur’an says “To Allah belongs to everything in the sky and on the earth” (2:284) Role of the man is considered as trustee who is to manage the trust i.e. wealth
according to the directions of the real owner, God Qur-an clearly states ‘And spend of that whereof hath made you trustees” (57:7) so man has been granted.

3.9 Postulates/Axioms/Assumptions

Postulates should reflect Sharia'h principles and values related to the economic problem. These postulates are then used as binding terms in the formation of hypotheses. Islamic economics embodies normative aspects and hence the postulates would be representing these. For example, an Islamic theory for the firm will include the following normative postulates: According to Abdel – Rahima Yousuf Ahammed of University of Alexandria Egypt in his study on Theoretical Approach to Islamic Economic (2002)

The firm must not follow any restrictive production policy or get involved in any implicit or explicit agreement with other producers in order to limit supply and influence market prices (monopoly and monopolistic practices are absolutely forbidden).

The firm must not follow any methods to affect the price indirectly by cheating on the quantity. Also, it should not lower the quality to achieve additional profits (prohibition of fraudulent behavior).

The firm shall guarantee the workers' rights according to rules prevailing in the labor market and shall not follow any monopolisist methods in purchasing its
production requirements (workers must be given their just wages rightly in time). Also concluding deals with sellers before reaching the main market is forbidden.

(Sainudheen Mugdoom – Fathhul Muheen)

Now let us think of how to formulate postulates based on actual observations and empirical data. When an Islamic economic system is fully applied, actual observations should not contradict normative postulates derived from Sharia'h. This assertion, however, will only materialize in an exceptionally ideal circumstance. Especially during the period of prophet (PBUH) and the for caliphs who follow him).

At present, we ought to realize the gap between the normative aspects and the actual conditions in Islamic economics. This gap is large and if we depend on actual conditions in forming assumptions for our theory, most probably we shall find no difference between Islamic and conventional economics. Such gap may still however be justified on basis of 'darrorah' i.e. Sharia'h necessity rule, which is presumably suitable for transition when moving from a condition where Sharia'h is not applied, or only partially applied, to another when Sharia'h is completely in application. In this case of darrora, it is possible to reflect actual conditions as realistic assumptions along with postulates derived directly from the Islamic Sharia'h principles and values. The theory which is based on this mixture will be only transitionally valid and has to be evolved whenever changes in economic aspects of the society take place towards "what ought to be".
3.10 Hypothesis

In the empirical method a hypothesis is formed through "enumerative induction" in which it is inferred that what is true for "a number of observed cases" that are related to a certain phenomenon is true of all such cases. A hypothesis would take into account the conditions that are surrounding the phenomenon in practice through the assumptions that are based on observations, and identify the principal factors affecting it in order to explain it. Thus a hypothesis would enable us to identify the factors that would cause certain event to happen and predict its outcome. This method can be used in formulating an Islamic economic theory only when there is an actual experience wherefrom data can be collected. For example, it is possible to collect data on Islamic banks at present and to formulate a hypothesis concerning their effect on investment in limited number of cases. Similarly, information on zakat can be collected to study its effect on income distribution or on low-income groups' consumption.

3.11 The Role of the Economic History in Research and Analysis

While theoretical analysis is an important tool of economic research, it is not the only one. There are other necessary and important tools. Ibn Khaldun in his brilliant work "The Introduction" used four major tools for analysis, with the logic of economic history topping the list. Economic history, whether recent or past, displays economic experiments whose results and dimensions become known facts. Economic
history can be used in the analytical process by reviewing the events and their sequence over the time to understand their causes and effects. Even though economic events do not repeat themselves, yet to learn their logic as to "why events happen" circumstances that accompanied them and their consequences can be very useful in explaining other events of similar nature and making some predictions on their possible effects. This is the essence of the logic of economic history.

The study of economic problems through history also reveals the relationship between these problems and the other phenomena. In this respect, Islamic economics, as a new paradigm, stands to benefit a lot from the Islamic historical experiences in the past.

Al-Maqreezi (1364-1441G) a prominent historian and a brilliant follower of Ibn-Khaldun had also given full consideration to the historical factor in analyzing the reasons of hyperinflation that he witnessed during his life in Egypt. Using historical evidences and explaining their logic he was able to discover that natural forces had caused cyclical fluctuations in agricultural crops and consequently in their prices over the long run. He then demonstrated how monopolists had always played a serious role at different times in accentuating the effects of food supply shortages by keeping high stocks in their stores and deliberately triggering further increases in prices.

A careful reading of Al-Maqreezi's contributions would show how the fact-finding process that he adopted depended immensely on detecting the historical events and explaining their logic [Yousri (2000), pp. 129-36].
3.12 Commitment to the Scientific Approach and Applicability of Islamic Economics

Successful implementation of the Islamic economic thought in practice depends on appropriate commitment to the scientific approach that we have gone through above. Economic analysis of any problem or phenomenon starts only after the basic postulates have been formed. Thinking that we can depend "directly" on Sharia'h to formulate successful economic policies is misleading and may not only lead to failure in resolving the economic problems but perhaps would further complicate them. A crisis would arise and handicap the development of Islamic economics if Islamic jurists without consulting the economists are taking diversions on the basis of Shavia’h. Scientific operation between Islamic Economics and jurists is very important in theory formation in Islamic Economics on the basis of Sharia’h regulations). The theory formation for the implementation various Islamic Economic Instruments like, interest free banking, profit – loss sharing, Zakkath system as a good redistribution system. Etc:- the jurists and Islamic Economists should come together and they have to interpret and reformulate the principles in accordance to the contemporary economic conditions and fiscal needs with in shariah frame work. A couple of examples are given below for clarification.

A distinctive feature of an Islamic bank is that it would finance projects on profit-loss sharing principle instead of interest-based loans. However, necessary research concerning different modes of equity finance, the most appropriate modes of them that suit the current economic, social, and ethical conditions as well as how
to face the competition from interest-based banking system has not been done. Consequently, different problems have been faced in using the profit-loss sharing modes of financing and most Islamic banks ended up using the short-term financing instrument of murabahah. Some quarters has criticized this financial instrument in its practical implementation (not on Sharia'h basis) as being close to interest-based financing. When Islamic bank managers face problems in applying the new financing techniques they try to solve them either by relying on their own experience (which is mainly gained in non-Islamic banking), or by seeking the advice of Islamic jurists who work in the Sharia 'h boards of these banks. This advice, however, would be given in form of juristic principles that need accurate economic interpretations in order to be operational in reality. At times, the Sharia 'h board solved some serious banking problems through new fiqh devices, which could not gain consensus from Muslim jurists and have been frequently criticized by Islamic economists. Such problems would not have been confronted were all Islamic banking concepts and financing modes developed and elaborated theoretically on sound scientific bases.

3.13 Adaptability of Islamic Economics Methodology in Different Phases and Reflections on the Applicability of the New Paradigm

Siddiqi M. Nejathullah (1982) in his History of Economics through in Islam says that: Given the absence of a modern Islamic economic experience before 1970s, there was no room for the researchers to use induction. As a result, Islamic economists depended heavily on deduction. In this context, research in Islamic economics was generally normative.
It is important to appreciate that scientific development of Islamic economics in the early phase (after World War II) was in need of this deductive method. This methodology helped in exploring normative Islamic solutions to our economic problems and supported the call for an Islamic economics within a modern Islamic society.

The study of the Islamic economic experience using the inductive approach was also hampered by the lack of data on modern Islamic institutions. Available data declared in financial statements by Islamic banks is scant and sometimes difficult to get hold of. Similarly, non-governmental institutions that collect and distribute zakat in many of the Muslim countries keep their records confidential. These limitations, however, do not absolve researchers to conduct empirical work. They should conduct empirical studies based on whatever statistical data is available and rely objectively on approximate estimations for what is missing. For example some Islamic economic researchers have conducted empirical research to estimate expected zakat revenues in some localities as well as some Muslim countries. They used the inductive method but they resorted also to deduction to estimate in some of the missing facts.

It is quite important to have a long run Islamic strategy for reformation and gradual structural adjustment. This strategy should be undertaken for implementation by all concerned Muslims to push the wagon in the right direction. What concerns us is to highlight some necessary rules for research in Islamic economics that would be carried within the framework of the said strategy. Scientific commitment to these
rules would certainly help in making Islamic economic research applicable and fruitful to the Muslims.

The basic feature of the corrective strategy is its time dimension. Because it is expected to extend over a long period of time and works for gradual changes from non-Islamic to Islamic conditions the strategy need to be divided into time phases. Theoretically we can divide the time necessary to achieve the optimum conditions targeted by the strategy into various phases: Yousry, Abdul Rahiman (1999) discuss these phases under three heads 1) Darrora Phase 2) The intermediate phase 3) The structural change phase.

3.14 Darrora Phase

In Islamic fiqh some very exceptional situations may arise that would compel the Muslims to deviate from normal Islamic behavior or commitments. These very exceptional situations will call for darrora, i.e. necessity, rules. The darrora traditional cases are well-defined in Islamic fiqh.

The tasks of Islamic economic research in this phase are:

a) To analyze the emergency cases which are claimed by people to be calling for the darrora rules. For this job Islamic economic researchers need to collect as many observations as possible for each case. Call for continuous consultations
with the Islamic jurists and scholars will be essential so that the conditions of darrora in economic matters can be classified within the Islamic legal framework until the phase is over.

b) To guide the people engaged in economic activities in case of real darrora to the solutions that are "nearest" to the Islamic Sharia'h.

c) Since darrora by Sharia'h definition is a temporary period, and never permanent, research must determine the "time length" of this first phase. It should be clear that darrora phase should be terminated as soon as some better situation (not necessarily the optimum condition) has been attained from the Sharia'h standpoint.

3.15 The Intermediate Phase

The intermediate phase is a prerequisite for implementing the structural change which is needed in the final phase of reformation. The task of Islamic economic research in this stage consists of:

a. Collection of precise information and statistical data on the forces opposing the application of principles of the Islamic economy.

b. By targeting the weakest points of the opposing forces initially, methods and policies towards a gradual transformation of their economic activity from the secular patterns to the Islamic should be undertaken by researchers.

c. There is a need to seek medium term solutions for some of the economic problems from which Muslim society suffers under conventional economic systems. These intermediary or transitional solutions must be characterized by a clear account
and understanding of how a gradual transition will be carried from the behavior based on positive secular values and motives to one based on Islamic motives and values.

d. Devoting sufficient research to identify and analyze new activities that can be established on strict Islamic economic basis. These activities will be the pillars on which the structural change process will depend in the final stage. In this context, priorities should be assigned to different activities upon careful examination of their relative importance.

e. Principles of the Islamic economic system have to be publicized in the mass media and taught to students particularly at secondary and post-secondary educational institutions.

3.16 The Structural Change Phase.

This is the final phase and it begins only after successful completion of the 'intermediate phase' targets. This emphasizes the importance of Islamic economic research under non-optimum conditions. The fulfillment of complete structural change needs serious macroeconomic studies in the areas of optimum allocation of resources and fair distribution of income within the context of Sharia'h.

To conclude we can say the applicability of Islamic economics depends firstly upon adopting the right methodological procedures all the way in any theoretical contribution. Then in the next step on the researchers' efforts to minimize or eliminate the gap between theoretical work and the actual problems or needs of
their Muslim society. In this context we have to be aware of the fact that these problems and needs will be changing over the long period of time which is necessarily needed for transition from the present day's Muslim economies to Islamization. This transitional period can be divided, as suggested, into three distinctive phases. The successful application of Islamic economics will depend on exploring the particular problems of each phase and suggesting the right solutions to them from the Islamic perspective.

SECTION III

3.17 Fiqh Foundations of the Theory of Islamic Economics

According to Siddiqi (1989), the essentials of theory of Islamic economics are rooted in the Qur'an and Sunnah and the implications and implementation of these essentials are to be searched in other Islamic sources like Fiqh, Usool Fiqh and Islamic history. According to him, "a sincere commitment to Islamic beliefs and values changed everything in economics". Zarqa (1976) argues that distinct and meaningful economics is not only possible but also necessary. He not only elaborates on the positive economics statements from the Qur'an and Sunnah, but also argues that even conventional economics is not innocent of value judgements as we are often led to believe. According to him, if we replace non-Islamic values by Islamic ones, and add to the economists' stock of positive assertions, Islamic assertions, we will be able to work out a meaningful distinct science of Islamic economics.
Conventional economics, however, with its scientific approach and positive arguments has failed to solve the economic problems of humanity. As Sardar (1991) puts it, "This is because, first, neoclassical economics, being a positive discipline, does not play any active role in directing or controlling human behavior or economic events. It merely explains or rationalizes them. Second, some of its basic postulates such as inherent human selfishness, unregulated free enterprise, consumer sovereignty, the absolute freedom to earn, save, invest or waste, are instrumental in creating (various economic) problems. Solution to present-day economic problems requires a complete departure from contemporary conventional wisdom".

It is not merely the failure to solve the economic problems, but in fact the very foundations of the theory of economics that have lately become controversial. Neoclassical paradigm that was celebrated until the mid-seventies as the "economics" lost all its grandeur when the theory of rational expectations took away all the grounds underneath it. The economists are now said to be in search of a paradigm to replace the neoclassical synthesis. As a result, different schools of thought like New Classicals, New Keynesians, Post Keynesians, etc. have come up with different alternatives.

3.18 Objectives of Sharia'h (Islamic Law)

Objectives of Sharia'h form a logical starting point in the process of laying down the foundations of Islamic economics. The chapters in the book relating to objectives of Sharia'h have received special attention as it introduces new
dimensions. According to Shatibi, primary objective of Lawgiver is the maslahah of the people. Masud (1999) reproduces the following definition of maslahah from Shatibi: "(Maslahah) concerns the subsistence of human life, the completion of man's livelihood, and the acquisition of what his emotional and intellectual qualities require him in an absolute sense" in theoretical frame work of Islamic Economics and is treated as a vital part. Maslahah refers to preservation of the objectives of Sharia per cent which consists of preservation of following five aspects of human existence in the world:

i. Preservation of Life (Nafs).

ii. Preservation of Property (Ma 'at).

iii. Preservation of Religion (Deen).


v. Preservation of Descendents/Procreation (Nasl).

What assures and preserves these five conditions is considered to have maslahah and whatever fails to preserve any one of them is mafsadah. The removal of mafsadah also constitutes maslahah. There are three grades or levels of maslahah as follows:

i. Essential (Darori) Level

ii. Complementary (Haji) Level

iii. Amelioratory (Tahsini) Level

At essential level, maslahah would include all that protects the five elements (life, property, religion, reason and procreation) from destruction. Complementary
level refers to strengthening or expanding the preservation of the five elements. It also includes all such things that improve the quality of preservation of five elements or removes hardships in the preservation of five elements (beyond the essential level). Amelioratory level would include all that helps preserving the five elements in a beautiful or in a better way. It relates to aesthetic sense of human beings in achieving the five preservations mentioned above.

Economic agents operating in Islamic framework, will seek maslahah instead of seeking utility in the conventional sense. Maslahah and utility though may often coincide but the two are entirely different concepts. Whereas utility is a subjective concept emanating purely from individual instincts, maslahah is amenable to objective verification on the criteria mentioned above. In the Fiqh terminology, seeking the conventional concept of utility will be treated as pursuing instinctive desires and Islam disallows pursuit of instinctive desires (unless they have maslahah as defined above). This is because if the world is left to follow the peoples' instinctive desires, it will result into chaos and disorder in the world.

3.18.1 Wasting Resources or Keeping Them Idle Not Allowed

There are a couple of other issues that can be identified from the objectives of Sharia'h that influence economics but have not been recognized by conventional economics. Conventional economics, for example, assumes existence of economic man. Economic man takes decisions that are rational. Some issues, however, are not addressed in economics. For example, what would make a man to behave
economically? What can make people to work for improving their economic condition? How to deal with the people who prefer to remain in poverty rather than forego their leisure? How can people be forced not to waste resources and not to make their uneconomic use? Such topics may be the concern of what is called "Development Economics" which has yet to go a long way to understand and cure 'underdevelopment' or economic backwardness.

Islamic law shows clear concern to this and is reflected in various rules laid down for human behavior. Hassan's (1998) discussion on objectives of Sharia'h for example highlights the following rules.

Rule: To work/produce is a religious duty. Not working is not an option available to those who are able to do so. Private property rights have been defined in a way to re-enforce this.

Rule: Since it is the objective of Shari'ah to save property, from destruction hence property cannot be entrusted to those who lack reason to use it rationally even though they have clear private property rights in it.

3.18.2 Principle of "No Risk, No Gain"

While economics assumes competitive conditions, Islamic Sharia'h gives specific rules to ensure that behavior of economic agents promote competitive conditions. There are, however, differences in the Islamic approach to markets particularly with respect to operations of factor markets. The principle of no-
liabilities (risk), no gain (no cost, no profit) does not allow malleable capital to earn a fixed rent unless it is converted into non-malleable capital. Furthermore, the conditions of renting which in fact are reflection of the principle of no liabilities no gain must also be fulfilled. This difference might not be significant when microeconomic analysis is done under certainty. However, when uncertainty is introduced in economic analysis or these assumptions are used as foundations for macroeconomic analysis, then there would be problems because return on financial or monetary capital is not similar in nature as rent on capital in the microeconomic framework.

3.19 Assumptions Relevant for Economic Analysis.

Al-Masri (1998) draws basic assumptions for the science of economics from the Fiqh literature. He identifies the Islamic counterpart of the following assumptions that, according to him, have been foundations of the development of western science of economics. These are the assumption of rushd as a counterpart of the concept of 'rationality' in economics, the assumption of 'scarcity', and the assumption of 'maximization'. Several fundamental aspects of Islamic economics emerge as we go into the details of some of these assumptions identified by Masri. This is done below.

3.19.1 The Assumptions of Rushd (Rationality)

Rushd can be interpreted as sound mindedness or ability to make sound judgments. The term rushd has been mentioned a few times in the Qur'an with
respect to the use of property rights on economic resources. Property rights on economic resources in the light of Qur'anic teachings are to be exercised with sound mind.

Islam thus not only recognizes the human economic instincts but also teaches, through various legal provisions and ethical norms through Qur'anic verses like 27:100, 3:14. The human instinct of niggardliness, which Qur'an refers to as being "qatoora" (in 17:100) towards social interest, is ignored when the theory of economics is built up on the principle of pursuit of self-interest. Ignoring this economic aspect of human behavior is likely to have stripped economics of the ability to address several questions that could be useful not only for the science of economics but also for its application to the economy to solve the economic problems of the society.

3.19.2 The Scarcity Assumption: The Economic Problem and the Definition of Economics

Masri discusses in detail the question whether resources are scarce relative to needs. He discards the position taken by some that in the context of Islamic economics, there will be no scarcity of resources relative to needs. He argues that scarcity will remain and hence the economic problem of how to meet unlimited wants with limited resources will also remain in the context of Islamic economics. He makes reference to verses of the Qur'an as well as some renowned explanations.
of the Qur'an to prove his point. Basically, he concludes that Islamic economics will take scarcity as well as the definition of economic problem of man in the same perspective as conventional economics takes.

There is no economic problem on grounds of scarcity. But there is economic problem in the sense of "rational" (in the meaning of "rashid") utilizing resources to fulfill the needs. This is the type of economic problem which is visible in almost all societies in varying degrees. The scarcity axiom will not help identifying this problem. On the other hand, if maslahah and hence needs (as explained earlier) alone is the basis for economic decision making then the above mentioned man is obliged to fulfill all his needs and his needs would be endless, if meeting social needs is recognized as individual need.

Scarcity is not the only concern when economic problem is to be seen as a problem of meeting needs rather than satisfying wants. The primary concern is to make sure that the resources are being allocated to meet the needs and needs do not get ignored while meeting instinctive desires.

3.19.3 Assumption of Maximizing Behavior

Masri (1998) believes that maximizing behavior (on the part of economic agents) is a valid assumption for Islamic economic analysis. He devotes bulk of his paper to justify this position and prove that this assumption is as basic and essential as it is in conventional economic analyses. Masri starts his arguments by quoting the
following verses from the Qur'an: "And come not near to the orphan's property, except in a better way" (6:152 and 17:34); "...He (Moses) said, 'Will you exchange the better for the worse?" (2:61).

From the discussion of Fiqh scholars on the responsibilities of custodians of the property of orphans, waqf and bait-al-mal, Masri generalizes the principles of selling goods at maximum price and making maximum profit when putting one's resources to commercial use. He quotes from traditions of Prophet (peace be upon him), Fiqh literature as well as from Ibn Khaldoon to conclude that to pursue the maximization of profit in exchange (in the market) is not only permissible but required. While there may not be disagreement on Masri's assertion that maximizing behavior can be adopted as a valid assumption for explaining Islamic economics, the grounds on which he draws this conclusion leaves more clarifications.

3.19.4 Prohibition of Gharar in Exchange

Gharar is prohibited in trading. It is difficult to define precisely the concept of gharar that makes a contract of exchange null and void. In layman's language it would generally mean leaving one or more substantive elements of the contract unclear, ambiguous, uncertain or doubtful, or concealed.

Al-Dhareer, a renowned contemporary Fiqh scholar, recognized particularly for his work on Gharar, explains in detail the concept in the context of contemporary transactions. He identifies the concealment of following elements that creates
doubt, ambiguity, or uncertainty and can cause gharar in the object of contract and hence make it null and void.

i) Entity types and attributes of the object.

ii) Quality of the object.

iii) Time of payment in Deferred Sales.

Gharar may also enter a contract on account of:

a) inability to deliver the object;

b) contracting on a non-existent object; and

c) contracting without seeing the object.

In theory, the prohibition of gharar in contracting exchange of goods and services in the market may not affect economic analysis. Conventional analysis may still be valid. It is the contemporary practice in the market that would distinguish Islamic market from conventional market.

3.19.5 Social Needs

Two important Sharia 'h concepts provide a wide and flexible basis for public policy to meet social needs in an economy. These concepts are the doctrine of necessity and the concept of maslah mursalah. A contemporary discussion on both these concepts can be seen in Abu Sulayman (1993) and Hassan (1994) respectively. These discussions lead to the principles and criterion that can be helpful in making social choices. The social welfare function thus becomes not only definable but optimizable as well, because these principles give explicit guidelines to prioritize
public interests, resolve conflict between private and public interests, and make objective interpersonal maslahah comparison possible.

Kamali's (1997) discussion on istihsan provides another potential tool for seeking new dimensions relevant for public policy on Islamic framework. According to Kamali, Istihsan is generic in that it takes for its scope almost the entire range of the ahkam both in the areas of mu 'amalat (dealings) and ibadat (worship). Furthermore, it seeks to harmonize the detailed rule of Sharia 'h in line with the broader objectives of Sharia'h. He adds, "Istihsan is focussed on finding a better alternative to a ruling or evidence of Sharia'h when its application has frustrated one of the objectives of Sharia'h.

3.20 Transactions in conventional and Islamic Economics

Mabid Ali-Al-Jarhi (1998) the director of IRTI of IDB, Jeddha in his studies on Transaction in conventional and Islamic Economics:- A comparison concludes his analysis that under competitive conditions, purchase on credit costs less than borrowing to finance spot purchases. Some observed market behavior confirms that result. Suppliers of durable goods sometimes join banks to offer financing packages to their customers, which combine borrowing and spot purchase in one deal, mimicking credit purchase arrangements.

Islamic banks usually offer credit purchase deals to their customers. In most countries conventional banks are not allowed to use similar modes of finance, while
entry to the Islamic banking market is severely restricted. Some Islamic banks in such countries have the opportunity to take advantage of such monopolistic edge by charging markups, which would be higher than market rates of interest, presumably by the expected savings in transactions costs. We can therefore conclude that a policy that lifts entry barriers facing Islamic banks and allows conventional banks to combine commerce with banking activities contributes to social welfare.

A further complication relates to the pattern of behavior towards liquidity in economies with debt of limited marketability. In such economies, money defined broadly would contain a shorter list of quasi-monetary assets. In addition, credit purchase should have satisfied some "monetary needs" the resulting debt would satisfy some more, albeit within a limited scope. Analysis of the financial market in such economy would need to consider the full menu of financial assets to see to what extent people who wish to maintain a certain degree of liquidity can do so.

Finally, we have so far assumed that borrowing would be made exclusively for the purchase of commodities and real assets. It is possible though that people would borrow to finance the purchase of nominal assets. This would be mainly for speculative purposes. Here we need to know how such transactions would affect output on the one hand and whether it would have some bearing on economic stability.
SECTION IV

3.21 Analytical Tools of Islamic Economics: A Modified Marginalist Approach

If Islamic Economics had to develop as a discipline, it is important to clearly identify the analytical tools that can be used to discuss its theory. Analytical tools are used to analyze the fundamental issue of how choices are made and help study the micro-foundations of economic theory. We can argue that a modified neoclassical marginalist approach that integrates the Islamic values can be used to study Islamic economics.

Habib Ahamed discussed the importance of analytical tools in examining the micro-foundations of economic theory in Section 2. Given the lack of generally accepted analytical tools in Islamic economics, he explains the scope of using neoclassical (marginalist) analysis in the discipline. To do this he first identifies the principles of marginalist analysis in Section 3 and then examine their compatibility with Islamic values in this section. We can conclude that economic behavior of individuals based on Islamic principles can be modeled using modified marginalist analytical tools. In Section 5, we use these modified marginalist analytical tools to demonstrate two specific examples. First example shows a consumer's choice problem and the second one examines the behavior of a firm imbued with Islamic values. Though the neoclassical analytical tools are used in these optimization processes, consumption and production of goods (and as such resource allocation) in
an Islamic economy turn out to be different from a conventional one. Section 6 concludes his work.

### 3.22 Need for Analytical Tools.

The need for the analytical tools in economics relates to very basic issues. Tools are needed to analyze the micro-foundations of an economy on which the fundamental theories are based on. In the absence of analytical tools, study of an economic system becomes perplexing.

Similarly, analytical tools are needed to clarify the implications of certain claims made in the discipline. For example, some Islamic economists maintain that a firm's objective is not to maximize profit only. Instead, it is asserted that in the Islamic framework the objective of a firm has both profit and social considerations (Al-Habshi 1992, Mannan 1991, Siddiqi 1992). For example, a producer imbued with Islamic zeal may produce a good that is beneficial to the society in larger amounts even if it yields lower profit. Such an approach raises some important questions from an analytical point of view. First, given the Islamic ethics, how can the above-mentioned result be shown by studying a firm's production decision at the micro level. It is important to analyze the issue as the firm's behavior forms the foundations of the supply side of the market.

According to Prof: Habib Ahamed though the paradigm of an Islamic economic system is different from the neoclassical one, the basic principles of the
marginalist analytical tools do not contradict Islamic principles and can be used to study the underlying behavior of agents in an Islamic system.

### 3.23 Neoclassical Marginalist Tools of Analysis

The origins of marginalist analytical tools can be traced back to the founders of the neoclassical school (Jevons, Menger and Walras) in the early 1870s (Walsh and Gram (1980)).

They addressed the fundamental issue of choices that individuals make as consumers and producers and the resulting allocation of scarce resources to alternative uses in the economy. This contribution was so significant that it is termed as the "marginal revolution" [Blaug (1996) and Walsh and Gram, (1980)].

Jevons saw economic problem as an "optimum resource allocation" problem [Walsh and Gram (1979)].

The main features of the choice process of the marginalist school that laid the foundations of the neoclassical economics are given below:

a) Use of Mathematics in Analysis: The fundamental principles of economics are given a mathematical form to make the subject more scientific (Walsh and Gram 1980, p. xi). Continuous functions were used so that calculus could be used. The maximization behavior, however, is equally applicable to discontinuous functions [Blaug, (1996)].
b) Scarcity and Feasible Allocations: The concept of scarcity is derived from the dual notions of limited resources and unlimited wants. The implication of scarcity is that not all allocations are feasible.

c) Optimization: Economic agents make their choices in order to optimize some maximum end, i.e., maximize some objective function. In conventional economics, a rational consumer is said to maximize his utility and a firm maximizes profit.

d) Diminishing Marginal Utility in Consumption and Diminishing Marginal Productivity in

Production: Whereas diminishing marginal utility is a behavioral assumption, diminishing marginal productivity is a technical proposition. According to the former, as a consumer consumes more of a good in a period of time, the satisfaction derived from each additional unit declines. Similarly, in production diminishing marginal productivity states that as more of a (variable) input is added to a fixed quantity of an input, the output produced by additional units of the variable input decline. Postulation of diminishing marginal utility in consumption and diminishing marginal productivity in production is necessary for optimum solutions.

e) Choices based on Marginal Analysis: Choices among the feasible allocations are made at the margin. Economic agent's choice decision for an additional unit results by comparing the marginal benefit and the marginal cost of the unit.

Efficiency: Efficient allocation implies that "each unit of the dividend is apportioned in such a way that the gain of transferring it to one use will just equal the loss involved in withdrawing it from another" [Blaug, (1996)].
Neoclassical economics has used equi-marginal principle in a wider context to explain different aspects of the market economy (Blaug 1996, p.280). In the next section, we discuss the above-mentioned marginalist principles in the light of Islamic values to determine if they can be used as analytical tools of an Islamic economy.

3.24 Marginalist Analytical Tools and Islamic Principles: Are they Compatible?

Given the main features of the neoclassical marginalist approach above, we examine if these can be used to study the choice process in an Islamic context, according to Nomanic and Rehnama (1995).

a. Use of Mathematics in Analysis: This issue does not directly fall in the realm of Islamic values as it deals with the approach of studying the subject. It must be noted that the objective of mathematical modeling is to simplify the complex real world and deal with the main issues by leaving out the minor details.

b. Scarcity and Feasible Allocations: Islamic economists have different views on scarcity of resources and the economic problem. One view is similar to the conventional one where scarcity of resources and unlimited wants coexist. As mentioned above, the implication of this assumption is that not all allocations are feasible. The second view among the Islamic economists is that there is no relative or absolute scarcity. Rather, the problem is that of injustice and mal-distribution. The
third view takes the middle ground asserting that God has provided sufficient resources.

3.25 Applications of Marginalist Analytical Tools in Islamic Economics: Examples.

In this section, we discuss a couple of cases to show how Islamic values can be incorporated into economic analysis. First, we examine the demand side where a Muslim consumer allocates his budget to different uses. In the second case, we deal with the supply side where decisions of a firm imbued with Islamic values are discussed.

3.25.1 Case 1. Consumer’s Optimization Problem from an Islamic Perspective.

Before examining the optimization problem of a Muslim consumer using marginalist analytical tools, we first discuss some of his features discussed in the literature. The goods in the consumption bundle under Islamic perspective should be only those permitted by Islam, i.e., a Muslim individual consumes halal goods only. In other words, a consumers following Islamic rule consumption set includes tayibat (select things) (Naqvi,(1981)). Once the forbidden (haram) goods and services are eliminated, allocation of resources for consumption should follow Shatibi’s hierarchy order (Khan, (1992) and Zarqa, (1989). Accordingly, resources should first be allocated to the essentials (necessities). If resources are left after the need for
essentials of all in the society are met, they can be allotted to complementarities or conveniences (comforts) and then ameliorations or refinements (luxuries).

As mentioned above, the objective function of a consumer under Islamic principle is the attainment of i�alah or masalih. This implies, as Khan (1984) postulates that the utility of a consumer depends on spending on worldly needs (consumption of goods and services) and spending for others to earn rewards in the Hereafter. His consumption allocation is different from that of a conventional one as his utility function embodies ethical features and his constraints include both income and religious considerations. Similarly, Kahf (1980) postulates that the utility function of a Muslim consumer is a function of the money spent on himself (goods consumed) and spending on others for the sake of Allah (SWT). The allocation between worldly spending and spending for others depends on the consumer's taqwa (God consciousness).

3.25.2 Case 2. Producers Optimization Problem from an Islamic Perspective.

As in Case 1, one first describes the nature of a producer under Islamic system as discussed in the literature to identify his main characteristics. Metawally (1984) suggests that an objective function of an Islamic producer should include profit and giving charity. Iqbal (1992), among others, questions this assumption in a profit sharing mode of production. He maintains that a partner does not have the right to distribute charity out of common profit. One way the charity issue can be resolved is to separate the production decision from the consumption decision. The
firm makes optimal decisions in production with the resulting profit distributed among the owners. The owners then make a decision regarding allocation of income in different uses, including charity, as discussed in Case 1 above.

Though it is agreed upon that the objective function of a producer under Islamic system will not include charity, his production decision will be influenced by the profit motive and other social factors. According to Al-Habshi, (1992), the objective of an Islamic producer is to attain falah and will include profit and other goals. Siddiqi, (1988) maintains that the objective of an economic enterprise is to attain satisfactory profits. Satisfactory profits may be different from the profit attained by profit maximization in the neoclassical sense as social and ethical factors will affect the production decision. He asserts that a Muslim producer will not produce things that are forbidden, produce fewer luxuries and more necessities. He further asserts that more resources will be used to produce cultural goods and services (education, intellectual enlightenment, etc.) as they benefit the society.

Similar views are expressed by Mannan, (1991), who postulates that the objective function of a producer is economic welfare.

3.25.3 Case 3. The Nature of the Islamic Firm

Different forms of businesses based on Islamic principles of trade and finance have emerged in recent past, more significant being emergence of Islamic banks and some Islamic firms like mudarabah companies in Pakistan and some other countries. However, a theory of the Islamic firm is in its nascent form, primarily emphasizing
on the role of exchange in production relations and trade of resources within the firm. The emphasis on trade perhaps stems from the Qur'anic prohibition of interest and permissibility of trade and profit. This development coincides with the emergence of transaction cost economics and the new theory of the Islamic firm, which stress on trade and contracts in formation of the firm.

The theory of the firm has evolved from its 'production function' view that says nothing about the nature of relationships, dynamics of decision-making and internal organization of factor inputs, to transaction costs, institutional, and other approaches under the new theory of the firm.

The Islamic firm can be defined as a community of autonomous people (individuals) who are contractually bound to co-operate with each other to employ and account for factors of production to produce goods and services with an ultimate objective to sell and profit. This view is not different from the usual idea of an organization in which structure of authority is defined with respect to a group of people or a set of roles (Simon, (1957), Arrow, (1975), Mirrlees, (1976). Principle assets of the Islamic firm are not its physical resources and capital but entrepreneurial skills of the individuals who make up the Islamic firm. In contrast to Grossman and Hart (1986), Hart and Moore (1990) and Hart (1995) the Islamic firm is viewed as a set of individuals owning non-human assets to be used in production process.
Another distinguishing characteristic of the Islamic firm is that its capital structure is based on either of three sets of equity-based modes of financing, namely, Profit Loss Sharing (PLS), Profit Sharing (PS), and Output Sharing (OS). PS is based on principle of mudarabah, a contractual arrangement between two or more parties in which one party provides capital to another that contributes entrepreneurship in a business to share profits according to a pre-agreed ratio. The losses are borne by the capitalist with no financial liability on the entrepreneur. PLS is employed in partnerships, known as musharakah wherein two or more parties wishing to start a joint venture pool their resources to be residual claimant on the income stream of the business. While the profits in a musharakah may be distributed in any ratio, the loss should be borne by the parties involved according to their capital shares. Many consider such sharing arrangements to be inferior (Hart and Moore, 1990). However, many of these models assume symmetry of information between transacting parties. If informational asymmetry is considered, it can be shown that a PLS-based mudarabah contract may serve as an efficient revelation mechanism Presley and Sessions, (1994). The argument is similar to Reid (1973) who argues that sharecropping in agriculture. Uthman (1994) argues that a PLS contract may give rise to less opportunism as compared to debt finance. Referring to the use of junk bonds in corporate financing, he argues that debt financing provides a market mechanism that may invite and facilitate opportunistic tendencies.

Alchian and Demsetz (1972) explains a provision, there is a provision for sharikah al-mufawada (equal partnership) that necessitates equal partnership in capital, profit and loss, and liability. Moreover, there are a number of contractual
arrangements for small-scale business including, inter alia, partnership in artistic or professional intellectual skills, and business based on acquisition of resources from consumers by promises of future delivery (bai al-salam) for model explanation see Ken Baldwin’s thesis on “Determining moral hazard and Adverse selective in the Islamic Firm 2000 AD.

SECTION V

3.26 Portfolio Choice and Asset Pricing in Islamic Economics

Zemir Iqbal (1991) in his Research paper on Portfolio Choice and Asset pricing in Islamic frame work finds that investor in Islamic economic system will be a risk averse utility maximizing mean-variance optimizer who will diversify portfolios based on mean and variance of expected returns. Investor's preference for 'asset-backed' (fixed-return) instruments over equity partnership will also be influenced by degree of market completeness and informational asymmetry. Capital Market Line (CML) in absence of a risk-free asset and unrestricted short-selling will be non-linear and its linearity will largely depend on Sharia'h acceptance or rejection of short-selling. A linear capital market like in Islamic economic system will be possible under conditions of complete markets with large number of assets.

Zemir Iqbal suggests a design for Islamic Floating Rate Notes (IFRNs) based on Sharia 'h compatible 'asset-back' (fixed income like) securities, which can be used in private and public sector to finance activities suitable for 'asset-back' Islamic
instruments. With the acceptance of IFRNs, firms may be able to lower weighted average cost of capital by combining IFRNs and equity capital. However, the weight of IFRNs in cost of capital will depend on the nature of business and how much of it can be financed by IFRNs.

Table No.3.1

**Difference Between FRN and IFRN.**

<table>
<thead>
<tr>
<th>Factor</th>
<th>FRN</th>
<th>IFRN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal</td>
<td>Protected. Exposed only to insolvency of borrower.</td>
<td>Semi-exposed. Exposed only during the acquisition of asset. Once delivery is made to the entrepreneur, principal is exposed to insolvency of the borrower.</td>
</tr>
<tr>
<td>State Protection</td>
<td>Protected by bankruptcy law.</td>
<td>Protected to the extent of the value of goods being financed up to time of delivery.</td>
</tr>
<tr>
<td>Coupon Rate</td>
<td>Linked to interest rate.</td>
<td>Linked to profitability or demand and supply of goods being financed.</td>
</tr>
<tr>
<td>Exposure</td>
<td>Default risk</td>
<td>Exposure is minimized as IFRN is backed by a real asset, which can be liquidated in the market at current market prices, and proceeds can be used to recover funds.</td>
</tr>
<tr>
<td>Collateral</td>
<td>Firm’s credit rating</td>
<td>Tangible asset</td>
</tr>
</tbody>
</table>

Source: Zamir Iqbal (2000), IRTI Jeddah, Senior Information Officer Treasury Operation Department of World Bank. Washington D.C. USA
It is also suggested that in a well developed market of IFRNs, an efficient index of IFRNs will be representative of activities in the real sector and therefore return on index will be close proxy for the return on real sector. Further research is required to understand how risk and assets can be priced in Islamic economy if return on IFRNs index is accepted as proxy for return in the real sector.