

## **Impact of Interaction of Formal and Informal Institutions on Economic Growth and Development in the Framework of Islamic Economics**

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In this real world formal and informal institutions<sup>2</sup> are working simultaneously. The construction of the social, economic and political models is generally based on the interaction of these two institutions, i.e., formal and informal. Economists, sociologist, political scientist and experts from the different related fields are trying to find the impact of the interaction of these two institutions on the economic, social and political stability. It has been observed that the conflict in between these institutions have a negative impact on the stability, growth and development of the system.

It is a well known phenomenon that the ingredients and features of informal institutions are traditions, language, customs, moral values, beliefs, accumulated wisdom of the past and current set of values. Every society has its own particular informal institutions. However, the main and major ingredient is the belief of the society. Historically, It has been observed that different groups of people with the same characteristics except religion behaved extremely in the different dimensions.

On the other side formal rules are constitutions, statutes, common law, and other governmental regulations. They determine the political system (i.e., the governance structure and individual rights), the economic system (i.e., property rights and contracts), and the enforcement system (i.e., the judiciary and the police). Governmental authorities enforce formal rules by means of sanctions such as fines, imprisonment, and execution.

In the Islamic framework, both institutions have their own distinct features. The teaching of Islam is based on the *Quran* and the traditions of Prophet (SAW). It is believed by the Muslims that the rules given by these two sources are universal and their bases are forever. It is also believed that in the Islamic states both institutions have the maximum harmony with each other whereas have the minimum chances of conflict.

In this present study we will try to analyze either these two institutions are conflicting with each other or a cooperative one in the Islamic framework. We will also try to examine that these two institutes are able to develop their own economic incentives and transaction costs and how it is possible to change formal and informal rules in the periphery of *Shari'ah*.

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<sup>2</sup>The *institutions* as the legal, administrative, and customary arrangements for repeated human interactions. The prevailing institutional framework in a society consists of formal and informal institutions, the major function of which is to facilitate exchange through predictable human behavior in a world of uncertainty and incomplete knowledge. [ *Pejovich (1999)*, "The Effects of the Interaction of Formal and Informal Institutions on Social Stability and Economic Development", *Journal of Markets and Morality* 2, 164-181]. And Institutions, broadly defined, consists of informal constraints like cultural norms or the more purposive formal ones embodied in particular organizational structure (Lal D. 1999b).

The present study is organized in the following way. Section I discusses the basic definition and key concepts of the conventional economics (more emphasis on the institutional economics) related to the under study subject. Section II presents the economic incentives, transaction costs, property rights and nature of the contract in the Islamic jurisdiction. Section III will theoretically explore the interaction between these two institutions in the framework of Islamic economics and impact of this interaction on the economic development and growth. Section IV presents the conclusion.

## **1. Growth and its major ingredients in the Conventional Economics**

Currently most of the economies are following the western capitalist model. Especially the planner and policy makers of the developing countries are well equipped with the western economic thoughts. However, it is interesting to note that same policies have the different impacts on the different economies. The most important macro variables like growth rates, economic stability, level of unemployment, savings and investment are not same in the different parts of world even they applied the same economic models and policies and approximately following the same school of thoughts. After the old colonial period most of the previous colonies are applying the same rules, regulations and laws as have before their masters but their impact on the economic variables is entirely different.

Similarly most of the Muslim countries they are following the western economic models but the effect is not similar. For example, Malaysia and Korea have shown the different economic performance than Pakistan during the different periods even more or less their planning models are similar. Even apparently the gulf economies seem to be similar and approximately their economic and social models are not so much different but the pace of economic growth is not similar<sup>3</sup>.

The main objective of this paper to explore the relationship between the informal and formal institutions and the impact of this relationship on the economic performance, growth rates and the standard of living of the different economies especially in the Muslim Block<sup>4</sup>. We have to analyze why most of the Muslim countries following the western/conventional/secular models but their economies are not as much as efficient as the economies of the western world. A question arises that why a reasonable number of Muslim countries are not be graduated for development with a sufficient economic resources coupled with the successful western models.

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<sup>3</sup> Thus, according to Douglas North (1990), "Many Latin American countries adopted the U.S. Constitution (with some modifications) in the nineteenth century, and many of the property rights laws of successful Western countries have been adopted by Third World countries. The results, however, are not similar to those in either the United States or other successful Western countries. Although the rules are the same, the enforcement mechanism, the way enforcement occurs, the norms of behavior, and the subjective models of the actors are not [the same]". Douglas North, *Institutions, Institutional Change and Economic Performance* (Cambridge: Cambridge University Press, 1990), 101

<sup>4</sup> In most of the Muslim countries to some extent the informal institutions are similar but formal are changing from state to state. It is also observed from the data of growth and poverty (Azid and Chaudhry 2005).

In the literature of conventional economics one can see the different school of thoughts discussing the economic growth and its major ingredient<sup>5</sup>. Among them Classical, Neo-classical, Marxist, Keynesian and Institutional (old and new ) are more prominent. Classical economists have the opinion that economic growth based on knowledge, property rights and open market competition. However, according to its proponents that knowledge is not the only variable which is able to reduce the effect of law of diminishing returns in the production of goods. Consequently policies followed by the classical model are not able to describe properly the sustained economic growth even in the western world. Neo-classical school of thought which is well recognized in the world of economics is based on the very strong assumptions like maximizing behavior, stable preferences, marginalism and market equilibrium and also has limitations in the solution of the real world problems<sup>6</sup>.

In conventional economics, the theoretical models are generally based on the economic variables<sup>7</sup>. For example, the construction of an objective function of a firm primarily emanates from the maximization of profit and minimization of the cost. Seldom do 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 (Azid and Asutay 2007; Azid *et. al.* 2008). This model does not able to solve the issues of positive transaction costs, many different property rights and incomplete knowledge<sup>8</sup>. The current financial crises of the world especially the developed world is a very prominent example of the failure of the neoclassical economic model. During the depression of 1930s Keynesian economics was emerged with more emphasis on the autonomous demand. Basic assumption was that the government has the knowledge about the social welfare function and control of the government for the implementation of its policies is the necessary part and parcel of its growth programs. However, the decade of 60s and 70s have seen the hyper-inflation with less growth<sup>9</sup>. Marxism was emerged in the world of economics due to the reaction of the capitalism and the class system which was prevailed at that time and also exploitation was badly felt by capitalism. Poor segment of the world at that time had the higher hopes from this system but unfortunately the world has seen the end of Marxism. What Marx

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<sup>5</sup> Bernstorff (2004) has conducted a rigorous comparison of different school of thoughts and his special emphasis was on old and new institutional economics.

<sup>6</sup> 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).

<sup>7</sup> The economist's model of "Homo Economics" which assumes that human beings are motivated purely by self-interest: maximizing utility as consumers and profits as producers subject to budget and resource constraints. Hence the function of the rules constraining human nature must be to limit such self-seeking behavior. (Lal D, 1)

<sup>8</sup> The only institutions existing in [the neoclassical model] are markets of the competitive type in which all information on the economy must be transmitted through the prices formed in these markets. The economy is therefore assumed to have ... none of the many social institutions that are created by societies to help coordinate their economic and social activities by offering information not available in competitive prices. (A. Schotter, "Why Take a Game Theoretical Approach to Economics?" *Economie Applique* 36 (1983): 675)

<sup>9</sup> Cagan, Phillip (1956). "The Monetary Dynamics of Hyperinflation", in Friedman, Milton (ed.). *Studies in the Quantity Theory of Money*. Chicago: University of Chicago Press

predicted it was not realized in the real world. It was felt that it is another type of the exploitation from the red bureaucracy.

After the second world war most part of the world implemented the policies which were designed and proposed by the above school of thoughts especially for their development and the achievement of their growth targets. Unfortunately in most of the developing countries these policies could not be able to achieve their targets. A number of reasons were given, i.e., lack of proper utilization of resources, lack of capital, lack of proper human resource development and management, interference of the international institutions, economic and political instability and so on. However, none of them is properly qualified. We can see a number of examples that rich resourced economies are not able to perform very well, for example East European economies and the economies of Gulf states. Similarly some countries had applied the same economic models but their economic performance was not similar like Pakistan and Korea. India, China and Pakistan were the British colonies and they got their independence during the late forties but their economic performance is different during the different patches of time. Some African countries have enough resources for the achievement of their growth targets but they are failed to achieve it like Zimbabwe and Sierra Leone.

Institutional economics<sup>10</sup> emerged as a new school of thought with the more emphasis on the transaction costs, information problems, and bounded rationality. Methodology of institutional economics based on the social as well economic issues<sup>11</sup>. Concerning the issue of growth, new institutional economics explains that how institutions (informal and formal) significantly play their role in the economic and political stability and economic growth. According to its proponents that always one can see creation of new opportunities through exchange during the process of technological change and creation of new knowledge but not possible without the transaction cost. *Pejovich* (1999) concluded as "rational expectation theory brings the new institutional economics and neoclassical economics into proximity but not to convergence. Furthermore, rational expectation theorists consider the process of adaptation to an optimal solution as a steady trial-and-error process in which the participants cease to acquire new knowledge"<sup>12</sup>.

In short the literature of institutional economics gives us four major pillars on which its building has been established, i.e., informal institutions, formal institutions, property rights, and transaction costs.

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<sup>10</sup> The recent economics of institutions have four approaches: institutions seen as systems of (i) property rights laid by the law, (ii) moral conventions or norms, (iii) types of contract, (iv) authority relations. The common feature of these approaches is "the concept institutions as set of rights and obligations affecting people in their economic lives. (Matthews 1986, p.905)

<sup>11</sup> "the new institutional economics retains its general attachment to neoclassical economics with its emphasis on individual maximization and marginal analysis, but with attention to transaction costs, information problems, and bounded rationality." [G. Libecap (1998), *The New Institutional Economics and Economic Development: A Working Paper* (Torino, Italy: International Centre for Economic Research, 4].

<sup>12</sup> [New economic theories] are not focused upon, or even much concerned with, how variables are equated at the margin, or how equilibrium is altered by marginal shifts in conditions. Rather, they are focused on qualitative and structural questions, typically, on the choice among a small number of discrete institutional alternatives (H. Simon (1978), "Rationality As a Process and As a Product of Thought," *American Economic Review* 68, 6).

## 1.1 Informal Institutions

Informal rules are traditions, customs, moral values, religious beliefs, and all other norms of behavior that have passed the test of time. Informal rules are often called *the old ethos*, *the hand of the past*, *the habits of the heart*, or *the carriers of history*. They embody the community's prevailing perceptions about the world, the accumulated wisdom of the past, and a current set of values. Thus, informal institutions are the part of a community's heritage that we call *culture*. They are maintained from one generation to another through various transmission mechanisms such as imitation, oral tradition, and teaching. The enforcement of informal rules takes place by means of sanctions such as expulsion from the community, ostracism by friends and neighbors, or loss of reputation. In the process of enforcing informal rules, tribal chiefs and religious leaders have been (and, in some parts of the world, still are) known to use more severe forms of punishment. Material beliefs can change rapidly, as the institutions based on them, for example, systems of property rights, with changing factor and commodity prices<sup>13</sup>.

According to North (1990) informal institutions are: extensions, elaborations, and modifications of formal rules; socially sanctioned norms of behavior; and internally enforced standards of conduct. Informal institutional structures are generally located outside the formalized routines of governance and provide the medium where decision-making and bargaining take place (Hillier 2000).

In the typical literature we cannot find a single definition but they all share the notion that informal institutions – such as family and kinship structure, traditional practices and social norms. Sindzingre (2006) explained as: "norms and contracts are said to be formal not only because they are written, but also because they are guaranteed by a governmental legal system, in contrast with norms that are maintained 'privately' by social groups (e.g., traditions) through personal transactions and reputational mechanisms." (p.5-13)

## 1.2 Formal Institutions

Formal rules are constitutions, statutes, common law, and other governmental regulations. They determine the political system (i.e., the governance structure and individual rights), the economic system (i.e., property rights and contracts), and the enforcement system (i.e., the judiciary and the police). Governmental authorities enforce formal rules by means of sanctions such as fines, imprisonment, and execution (Pejovich 1999).

According to Hodgson (2001) formal institutions, generally as explicit legal rules, represent the dominant context for market operation. Knight (1992) defines as: formal institutional rules represent those constraints which are more explicitly socially shared. On the other hand North (1990) argues that formal institutions constitute a relatively small proportion of total institutional constraints, formal institutions are seen to provide a level of stability to social and economic interaction. However, in many developing countries, laws benefitting the poor exist on paper but not in practice unless the poor push for their enforcement.

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<sup>13</sup> Lane-Fox (1988) and Pejovich (1999)

### 1.3 Property Rights

Property rights are relationships among individuals that arise from the existence of scarce goods and pertain to their use. They are not about the relationship between individuals and objects. The most common types of property rights today are private property rights, communal property rights, and state or public property rights. Institutions, in this framework, can be seen as containers that hold property rights. The more property rights a person has in a good, the closer his or her private cost is to the social costs of using that good, and the more incentives that person has for seeking the highest-valued use for the asset. That is, different property rights in goods create their own incentives through the impact they have on the relationship between the private and social costs of using those goods, which, in turn, affect human behavior in specific and predictable ways (Pejovich 1999).

For Alchian (1965), property rights are ‘the rights of individuals to the use of resources’ ( p. 817) not just under the law, but in reality. He makes clear that these rights are not solely dependent on the existence of the state, but that they depend on custom, reciprocity and voluntary restraints. Douglas (1999) argues that there is a monotonic relationship between property rights and wealth. According to Anderson and Lueck (1992) as property rights become better defined, the gains from trade increase. Other things equal, individuals prefer better defined property rights to poorer defined ones because they prefer more wealth to less.

Douglas (1999) explains that in general people are increasing their property rights in three ways: "First, the individual may steal the good in question. Second, the individual may privatize a good that was previously in the public domain. Finally, an individual may cooperate with other individuals with an agreement to divide the new wealth in some fashion." Cheung (1974 and Barzel (1985) are both in view that efforts for the protection of property are positively correlated with theft.

### 1.4 Transaction Costs

Transaction costs are the costs of all resources required to transfer property rights from one economic agent to another. They include the cost of making an exchange (i.e., discovering exchange opportunities, negotiating exchange, monitoring exchanges, and enforcing agreements) and the cost of maintaining and protecting the institutional structure (i.e., the judiciary, police, and armed forces).

Douglas (1999) discussed the two distinct definitions of transaction costs, i.e., the ‘Neoclassical’ definition rests on the costs of trading across a market, while the ‘property rights’ definition centers on the costs of establishing and enforcing property rights. The connection between transaction costs and property rights is summarized in the "Coase Theorem", which defined as follow:

**Coase Theorem:** In the absence of transaction costs, the allocation of resources is independent of the distribution of property rights (Douglas 1999)

Property rights are defined as:

**Property Rights:** the ability to freely exercise a choice over a good or service<sup>14</sup>

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<sup>14</sup> Ellickson (1991) and Landa (1994)

When property rights are incomplete, individuals are always in the process of maintaining their existing property rights and attempting to establish new one. This leads to the property right definition of transaction cost.

**Transaction cost # 1:** the costs establishing and maintaining property rights<sup>15</sup>.

The first explicit statement of transaction costs as the cost of trading comes from Demsetz (1964) where he states that 'Transaction cost may be defined as the cost of exchanging ownership titles' (1988, p. 64). Although this type of definition refers to property rights, transaction costs only arise when an exchange of property rights takes place. This leads to the neoclassical definition of transaction costs:

**Transaction Costs #2:** the costs resulting from the transfer of property rights<sup>16</sup>.

A typical definition of transaction costs found in the conventional literature would be as follows: In general, transaction costs are ubiquitous in market economies and can arise from the transfer of any property right because parties to exchanges must find one another, communicate and exchange information. There may be a necessity to inspect and measure goods to be transferred, draw up contracts, consult with lawyers or other experts and transfer title. Depending upon who provides these services, transaction costs can take one of two forms, inputs or resources including time - by a buyer and/or a seller or a margin between the buying and selling price of a commodity in a given market. (Stavins 1995, p. 134).

The idea of transaction cost is the notion of ignorance. Neihans (1987) as: "That parties find each other, they have to communicate and to exchange information . . . goods must be described, inspected, weighed and measured. Contracts are drawn up, lawyers may be consulted, title is transferred and records have to be kept. In some cases, compliance needs to be enforced through legal action and breach of contract may lead to litigation." ( p. 676)

Matthews (1986) stated that there is a close relationship between the institutions and transactions costs. According to him "to a large extent transactions costs are costs of relation between people" (p.906). Lal (1999b) classified transaction cost associated with the efficiency of exchange relates to the costs of finding potential trading partners and determining their supply-demand offers and associated with policing opportunistic behavior by the economic agents relates to enforcing the promises and agreements. Lal (1999b) explained concept of transaction costs as defined by North (1990 ) and Williamsons (1987). He narrated as: "primarily concerned with the cost of opportunistic behavior, which arises for North, with the more anonymous non-repeated transactions accompanying the widening of the market, and for Williamsons, from the asymmetric information facing principal and agents, where crucial characteristics of the agent relevant for measuring performance can be concealed from the principal" (p.2).

Klein and Leffler (1981) defined as: transaction costs include any direct costs, as well as any concomitant inefficiencies in production or misallocation that resulted from them.

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<sup>15</sup> Allen (1981)

<sup>16</sup> Niehans (1987)

## 2. Institutions, Incentives, and Transaction Costs in the Islamic Framework

In this section an effort will be made to explain the institutional structure of the Islamic society and as well will try to shed a light on the formulation of informal and formal rules in the given environment. Islam is a comprehensive and universal religion that regulates not only asceticism, but also worldliness. Almost all social, economic, psychological, political, and military precepts are addressed in Quran. The religion of Islam is based on the five pillars and the objective of these pillars is to train the Islamic society for the purposeful life.

1. Unity of God (Tawhid): It represents a submission to the almighty God. It means a deep consciousness of the unity of direction, clarity of purpose, avoidance of wrongdoing, and of equality among people and human is accountable to him for all of its actions. And the status of human being is a just a vicegerent to Allah (SWT)<sup>17</sup>.

2. Fasting: Fasting conveys a sense of self-control and a community that is united in sharing pleasure and suffering. It also implies that humbleness and some hardship can sustain and enrich civic and organizational responsibility.

3. Prayers: The prayers five times a day indicates an obligation toward the Almighty, an undivided commitment to principles, and a time to reflect on spirituality

4. Pilgrimage: This is reaffirmation of responsibility and the strengthening of a commitment to supreme principles. It conveys a simultaneous celebration of unity, equality, and diversity of the community.

5. Alms: Obligation towards needy, gives the concept of brotherhood, sharing and purifying the soul<sup>18</sup>.

One can see that within the periphery of above five pillars how the norms of the Islamic society would be emerged. Some of the important norms are given below.

The most important is the moral and social duty of the society and the duty of the state is to narrow the gap between haves and have-nots and commitment to social and economic justice. Any sort of discrimination and exploitation is not allowed. This is the declaration of prophet (SAW) on the sermon of last pilgrim (*Haj*) that all people are equal<sup>19</sup>. If Allah (SWT) has blessed someone with worldly power he is not permitted to abuse this power<sup>20</sup>. Poverty is considered not a good norm for the society<sup>21</sup>. Tolerance and receptivity are the major trait of the society even towards religion<sup>22</sup>. In the system of Islam diversity is considered as blessing<sup>23</sup>. Prophet (SAW) and his immediate Caliphs did not discriminate among people based on race,

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<sup>17</sup> Human being is God's vicegerent on earth "I will create a vicegerent on earth" (2:30)

<sup>18</sup> Zakat (compulsory due for the have nots) is only for those who are poor and needy and those who collect it, and for those in whose hearts love of Islam is to be reposed and for the freeing of persons in bondage, and for debtors, and for spending in the way of Allah and for the travellers (9:600).

<sup>19</sup> Prophet (SAW) said at the event of his last pilgrim, "no preference of an Arab over a non-Arab", "A white has no superiority over black nor a black has any superiority over white except by piety and good actions", "The worst of men are those who buy and sell man"

<sup>20</sup> "Those who will oppress will soon know with what kind of welcome from God they will face"

<sup>21</sup> i. "Poor are friends of the Prophet" ii. Poverty is almost disbelief iii. Hoarding of gold and silver is not allowed.

<sup>22</sup> "There is no compulsion in religion" (2:256) and "To you be your religion and to me, mine" (109:6)

<sup>23</sup> "difference in opinion is a virtue"



faith, religion, nationality, status and etc. No room for gender prejudice, women are given rights to inheritance, education, and ownership of property. Tribalism or loyalty to one's tribe is sinful and considers as a legacy of an era of ignorance. It is worthwhile to note that collective punishment has no concept<sup>24</sup>. For the smoothness of the society, protecting the poor segment of the society from exploitation and for the promotion of usury is completely forbidden whereas trade is highly appreciated<sup>25</sup>. System of Islam is based on absolute altruism instead of "reciprocal altruism" and tit for tat is not appreciated<sup>26</sup> (a very famous story related to the Muslim soldiers during the war, every one sacrificed his life but offered water to his other Muslim brother). Hicks used to call the "economic principle" – "people would act economically; when an opportunity of an advantage was presented to them they would take it"<sup>27</sup>. No doubt this is the part of human nature but not a significant one, Islamic teaching are over and above of this phenomenon<sup>28</sup>. The conventional literature suggests that shame and guilt is the major instrument through which moral codes are embodied in the cultural traditions<sup>29</sup>. However, the fear of Allah (SWT), *taqwa*, is the main instrument of the Islamic culture. And the preferences to those who are more God conscious (*Muttaqi*). It is clear from the above discussion that the informal institutes and rules of Islamic society are more or less different than the conventional one. And if state's formal rules deviates from the basic norms which are for the guidance for the building of economy and society then certainly a conflict will arise and consequently a high transaction cost.

However, state as an integrated part of society has some moral and ethical obligations. At the time of formulating its policies/formal rules, it should have to incorporate social, cultural, moral and ethical variables besides the economic one. However, very limited studies can be seen in this area including religion as a variable in their discussion. It is the moral and social responsibility of the state to care the norms of the society while it is in the process of formulation of rules and regulations. Fortunately, the Islamic framework guides the economic agents towards the positive as well as normative aspects in all the fields of life. The main objective of an Islamic state is to maintain justice among all the members of society and increase the welfare of society without any biases. It is recommended that state should include the above mentioned components in its plans for the benefit of society.

Early Muslim scholars had also discussed the behavior of the state and its responsibilities towards society and community. It is a well known phenomenon that the Islamic system of governance works on the principle of no-injury or principle of *maslahah* which will minimize the

<sup>24</sup> "No bearer of burdens can bear the burden of others", (17:15)

<sup>25</sup> "Disperse through the land and seek of the bounty of God" (62:10) and "God hath permitted trade and forbidden usury" (2:75)

<sup>26</sup> Hirshleifer (1997) points out that reciprocity cannot be sufficient to generate the virtues which are normally identified with *unreciprocated* generosity, and that social order requires more than just reciprocity. He writes reciprocity "cannot by itself explain the extent of co-operation among non-kin. A system of exchange based on property rights must rest on more than self-defense and tit for tat responses. In particular, disinterested third parties have to be willing to engage in what has been called 'moralistic aggression' to defend victims and punish defectors. If so, reciprocity is not the origin of virtue. Rather, true morality-pro-social propensities motivated by principle or compassion rather than by expected compensation-must be there already if a system of trade and exchange is to be viable" (p.58).

<sup>27</sup> Hicks (1979)

<sup>28</sup> Certainly human being has been created on the best nature (with the perfect stature) (96:4)

<sup>29</sup> Ekman and Davidson (1994), Hirshleifer (1987), and Frank (1988).

transaction cost. 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 human being that how to develop morals, and how to use these morals to bring faster economic coordination among the different sectors of the economy/society.

Islam has its own rules, laws and regulations towards the nature as well as towards the economic perspective of state, which are more or less different from the conventional system. The Islamic norms are expected to change the policies and directions of the policies. The Islamic system appreciates those norms which are helpful in the reduction of poverty, and considers a cultural norm with such objectives as a benefactor of the community yet the functioning of the formal/informal institutions is guided by the teaching of *Qur'an* and *Sunn'ah*. In other words, Islam calls for socially responsible institutes. Generally two basic questions should be considered whenever someone tries to analyze the role of informal/formal institutes:

- (i) What contribution is the cooperation of the informal-formal institutes going to make?
- (ii) Who are the beneficiaries of the product of this co-operation

## 2.1 Transaction Cost

In the system of Islam as we have discussed elsewhere that one cannot see too much deviation in between informal and formal institutions so consequently less transaction costs. From the Islamic history we can find a number of examples. The case of banning of liquor at the time of Prophet (SAW) gives us the insight of the co-operation in between the formal and informal rules. No doubt informal rules are not policy variables but in the Islamic environment they become very important. Because of the spiritual nature of the actions sub-marginal behavior eventually becomes the marginal (from material to spiritual). As Pejovich (1999) said that transformation from traditional communities in to modern has a high transaction cost but it is not the same for the Islamic societies where transformation is not based on the high transaction cost. The societies are so much trained for the adoption of the *Shari'ah* rules which are compatible with the human nature. These are not man made. These rules are given by the supreme authority(God) where no chance of the error. In true spirit of Islam, conflict cannot be seen in between the informal and formal institutions.

Historically the leadership was changed without any transaction cost. Islam has prescribed the proper characteristics of the rulers (Caliph) and the duty of Caliph is to maintain the rules and regulations of *Qur'an* and *Sunn'ah*. Currently most of Leaders of Islamic world are reluctant to change the non-Islamic environment. Especially during the 60s and 70s they promoted the concept of nationalism among the Muslims of the different parts of the world, for example President of Egypt, Jamal Abdul Nasir was the champion of this campaign. However, Islam does not appreciate the concept of nationalism or no biasedness on the basis of tribes which someone belongs, tribes are only for the recognition of the individuals and this is not the symbol of recognition<sup>30</sup>. The order of the good deeds and asking not to do the bad things is the characteristic of the Islamic society. The institution of partnership (*Mudharabah* and

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<sup>30</sup> O mankind! We created you from one male and one female and distributed you in communities and tribes that you may recognize each other. Surely, the noblest among you in the Sight of Allah is he who is more pious. Surely Allah is knowing, Aware (49:13)

*Musharakah*) provides that environment in which partners are in better position to monitor their partners better than the employers which consequently lower the transaction costs.

Waves of the implementations of Islamic *Shari'ah* exist approximately all over the Islamic world but contrary it is the threat to the authorities, for example it is considered as a big threat to the landlords/politicians in Pakistan. Abiding the contract is the main ingredient of the Muslim community but unfortunately this is not the trait of most of the current leaders of Muslim countries. The basic norms are avoiding the interest, implementation of the *zakah* system, law of inheritance, disbursement of the charity and etc. All of these actions are for the reduction of the transaction cost.

Trust is an important ingredient of the Islamic society. However, trust is based on reputation and reputation is acquired on the basis of consistent behavior overtime. It is argued that community trust as a superior good to public trust<sup>31</sup>. In a trustworthy society which is the informal institution, the transaction cost of the exchange will be low. It has also been observed in most of the Muslim countries like the other developing countries bribery is on its peak because of the current conventional system. Whereas bribery is considered as curse in the system of Islam<sup>32</sup>.

Fundamental assumption of Islam is the intention rather than the results, this the criterion upon which work is evaluated in terms of benefit to the community<sup>33</sup>. Asymmetric information are increasing the transaction cost so Islam emphasized the transparent dealings based on mutual understanding because faulty conduct and acts of deception obstruct justice and limit freedom of action in the marketplace (importance of character and credibility)<sup>34</sup>. During the process of exchange an humble and greedless behavior is required<sup>35</sup> and the motives of the producer can be underlying as: He has to earn profit but as a human beings other objectives are also important, i.e., looking after the interest of others, improvement in the material, moral and aesthetic terms of the society, production of the essential goods and services (duty), and provision of employment and as a trustee, motive of profit maximization is not so much important. Mutual cooperation is highly desired and encouraging it that one can take the benefit from the other members of the society<sup>36</sup>. Islam provides a climate of work within which the ethical aspects are not separated from the Economic one<sup>37</sup>.

Corruption has a high economic cost whereas honesty, fairness, reliability and loyalty enhanced the efficiency of the economic agents, this is assumed as the byproduct of the social behavior.

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<sup>31</sup> Economist such as Douglas North, Oliver Williamson and Ronald Coase have developed an institutional perspective that argues that societies are generally efficient.

<sup>32</sup> "God cursed the one who gives and the one who receives bribery" and "Both those are giving and receiving the bribery are in the fire".

<sup>33</sup> "God does not look at your matters (shapes or forms) and wealth, rather God examines your intentions and actions"

<sup>34</sup> "He who cheated us is not one of us" and if buyer and sellers "conceal and tell lies, the blessing of their transaction shall be obliterated" and "Those who declare things frankly, will not lead to each other destruction"

<sup>35</sup> "Beware of greediness; it is the living poverty" and Two qualities are not found in believer: greediness and immorality"

<sup>36</sup> "Do not divide your property among yourselves falsely except that it be trading by mutual consent" and "why do you restrain your brother from that which will benefit him and is also profitable to you" and Qur'an says "Disperse abroad in the land and seek of God's bounty" (62:10)

<sup>37</sup> "The noblest of you in the sight of God is the best of you in conduct" (49:13) and "The noblest of you in the sight of God is the best of you in conduct" (49:13)

## 2.1. Property Rights in Islam<sup>38</sup>

Islam teaches the individual 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 center 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 state is expected to uphold such social expectations in order to reach a sustainable economy and society. From an Islamic point of view that individual 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'an* and *Sunn'ah*), 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 (*amanah*), and as such, property rights are subject to moral limits and used as a means of fulfilling ethical objectives – the *maqasid al-Shari'ah* (the objective of the Islamic way)", (Ahmad, 2003:195). It is a common understanding that the utilization of resources on a noneconomic 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 (Iqbal and Mirakhor 2004).

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 (2003) 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 Shari'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, state's property rights

<sup>38</sup> See Azid T., M Asutay and U Burki (2007) for detail discussion

also come under the same rules of *Shari'ah* as individuals. How individuals should manage their property is observed from the *Qura'nic* verse (4:29)<sup>39</sup> and also the Prophet advised not to waste resources, property and wealth<sup>40</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 state. Iqbal and Mirakhor (2004:57), therefore, emphasized that an Islamic state is expected to preserve the property rights of its stakeholders<sup>41</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 state or individual”. 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.

*Rububiyah* and *tazkiyyah* axioms of the foundational principles of Islamic economic system (Ahmad, 1979 and 1994) require that economic activity 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 state is expected to uphold the environmental equilibrium in its operations. It is expected that within this balanced and sustainable environment as defined by *Qura'nic* principles that the state's policy 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 *amanah*, or trust from Allah<sup>42</sup>. We can conclude as that religion is the most important ingredient of the culture of the Islamic societies, from the hierarchical point of view religious is on the top most for the Muslim Communities. Islam as a religion has its own strong and significant externalities. The reputation of the governments of the Muslim countries is not dependent on their performance but also on their reputation towards religion and its quality towards the transparency.

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<sup>39</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>40</sup> Related sayings (*hadith*) 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>41</sup> “Principle of property rights in Islam clearly justify inclusion of stakeholders into decision-making a 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 mal*’ and therefore will be considered unlawful by Shari[ah].” (Iqbal and Mirakhor, 2004:54-55).

<sup>42</sup> Khalid, F. and O'Brien, J. (1992), *Islam and Ecology*, London: Cassell.

### 3. How Institutions work in the Islamic Environment?

The relationship between the rules and the game is a two-way street. The rules affect the way the game is played but are, in turn, affected by changes in the economic conditions of life. The following teaching of Islam is suggestive of the relationship between economic growth and institutional change. The growth of output according to the law of *Shari'ah* and without the exploitation of other members of the society is highly appreciated. In this system new opportunities for exchange are automatically tuned in with the prevailing informal and formal rules otherwise it is not allowed if any change is out of the boundary of *Shari'ah*. It is worthwhile to note that formal and informal rules have their own limitations and they cannot change without the guidance of *Shari'ah*.

"Today, we observe change in informal rules, which provide social acceptance for the Pill, single motherhood, and live-in arrangements, not to mention change in formal rules that permit abortions and simplified divorce proceedings" (Pejovich 1999). Islam does not suggest this type of institutional change which creates a lot of problems and new issues for the society.

According to the *Shari'ah* those tasks are morally required which are for the survival and flourishing of the society<sup>43</sup>. Teaching of Islam prevents underhand competition, encourages a friendly society and a traditions of mutual aid<sup>44</sup>. The best example of mutual and friendly society in the Islamic economic system is the institution of *Shirak'ah* and *Mudharab'ah*. The main objective of trading and manufacturing is not only earning the profit but also the alleviating of poverty, motivating people to be persistent and engaged creatively in an appropriate profession, complementing human soul with verified knowledge, good manners, useful ideas, and responsible deeds and reaching salvation. According to a prominent Muslim scholars Ibn-i-Khaldun that the main purpose of trading and manufacturing is to:

- i) facilitating cooperation and mutual understanding among people
- ii) satisfying the needs of people
- iii) increasing wealth and influence
- iv) spurning the growth of cities

"It is my thesis that those changes in formal and informal rules are not a consequence of lower moral standards in the United States but the result of economic growth that has created new opportunities for gains. Thus, changes in formal and informal rules were necessary in order to exploit those potential gains. One can think of the social and economic consequences of those changes as the cost of economic growth" (Pejovich 1999). New opportunities for gain in the Islamic system is not like as we are observing in the current economic state.

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<sup>43</sup> Prophet (SAW) said "I commend the merchants to you, for they are the couriers of the horizons and God's trusted servants on earth" and "the honest, truthful Muslim merchant will stand with the martyrs on the day of Judgment"

<sup>44</sup> "He who brings supplies to our markets is like a warrior in the war for God" and "the truthful, honest merchant is with the prophets, and the truthful ones and martyrs"

### 3.1 Formal and Informal Rules: Conflict or Cooperation?

We must now address the relationship between formal and informal rules, which is by no means a new question. However, what is new is the systematic treatment of the relationship between formal and informal institutions in the Islamic framework. The following observable relationships between formal and informal rules are critical for the verification of the interaction thesis.

What is the guide line to the human being regarding this dimension.

- i. Man is God's trustee in the universe<sup>45</sup>
- ii. Each individual is endowed with various needs and has multiple goals<sup>46</sup>
- iii. A human being is a creature with two dimensions: The spirit of God and putrid clay<sup>47</sup>

So "human being is in an 'infinite direction', either toward clay or toward God, man is 'compelled to be always in motion. His own self is the stage for a battle between two forces that results in a continuous evolution toward perfection" (Shariate 1979)

Attaining perfection in Islam is not sin. Rather it is desirable and a virtuous goal. A reasonable balance for satisfying the needs "Seek through your wealth the gains of the hereafter without ignoring your share of this life" (28:77). How there will be an effort could be done towards maintaining the balance in between his needs<sup>48</sup>. Table 1 narrated it as:

Table 1

Level of Existence	Needs Emphasis
<i>Sawala</i>	Physiological and materials
<i>Amara</i>	Physiological, material, and psychological
<i>Lawama</i>	Physiological, material, and psychological, intellectual in addition to some spiritual
<i>Mutamainne</i>	All needs with considerable emphasis on spiritual ones

<sup>45</sup> "We offered the trust to the heavens, the earth, and the mountains; but they refused to undertake it, being afraid thereof. But man undertook it" (33:72)

<sup>46</sup> "Verily, (the ends) ye strive for and divers" (92:24) and "Man can only what he strives for" (53:39)

<sup>47</sup> "When your lord said to the angles, 'I will create man out of pure mud-molded clay. When it is properly shaped and I have blown My Spirit into it, you should then bow down and prostrate before him' (15:29)

<sup>48</sup> "Give a full measure when you measure out and weight with a fair balance" (17:35) and So Establish weight with justice and fall not short in the balance" (27:9)

No restriction on pursuing legitimate business<sup>49</sup>, quality in the tasks is very much appreciated<sup>50</sup>, justice is the norm and paying of someone's reward is recommended<sup>51</sup>, reliance on oneself is considered as an obligatory duty<sup>52</sup>, hoarding is a curse<sup>53</sup> and generous person is very close to Allah (SWT)<sup>54</sup>

Islam promotes a universal approach that considers all human beings as a single brotherhood, and encourages peace, tranquility 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 law, the right to privacy, the right to protest, the right to justice and the right to participate (Ahmad 2003).

Islamic institutions are based on *Shari'ah* principles which require them to operate in morally, ethically and socially responsible manner, i.e., conforming to the Islamic norms of business and economic activities. All of the formal and informal institutions have the same base which is described below:

- i. Principles of *Taqwa* (God fearingness)
- ii. Principles of *Maslahah* (public interest)
- iii. *Daf' al darar* (prevention of harm)
- iv. *Raf' al-haraj* (removal of hardship)
- v. *Laa Dharara wa la Dhirar* (neither harming or reciprocating harm)
- vi. *Rehma* (mercy)
- vii. *Ihsan* (kindness)
- viii. *Adel* (justice)

The culture of Islam is not based on the individualism. Islam is the complete way of life. Informal rules are known as *urf* which are the habits and taboos of the society but not has the conflict with the basic tenants of *Shari'ah*.

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<sup>49</sup> "Worship has seventy avenues; the best of them is the involvement in an honesty earned living"

<sup>50</sup> "God blessed a person who perfects his craft (does the job right)" and "God loves a person who learns precisely how to perform his work and does it right"

<sup>51</sup> "Your wage should be based on your effort and spending" and "one must give a worker his wage before his sweat dries (should be given on time)"

<sup>52</sup> "No one eats better food than that which he eats out of the work of his hand" and "no earnings are better than that one's own efforts"

<sup>53</sup> "The supplier is blessed and the hoarders cursed" and "whoever withholds commodities, is a sinner"

<sup>54</sup> "The generous person is closest to God, heaven, people and far from hell" and "He who removes a distress, God blesses in this world and the hereafter"



In the conventional literature it is assumed that formal institutions can suppress but cannot change informal institutions (Pejovich 1999). Literature suggests that formal rules can change informal rules (McAdam). Helmke and Levitsky (2004) expressed as: informal institutions interact with formal institutions as they affect outcomes in four stylized ways

1. complementary
2. accommodating
3. competing
4. substituting

**Typology of informal institutions:**

Outcomes	Effective Formal Institutions	Ineffective formal Institutions
Convergent	Complementary	Substitutive
Divergent	Accommodating	Competing

This typology is taken from Helmke and Levitsky (2004: 728).

Soysa (2006) explained the above typology in the following manner. In terms of the first, informal institutions are complementary with formal ones when they converge and the formal institutions are effective. Second, the informal institutions may accommodate the formal ones when they diverge and formal institutions are effective by not violating the letter of the law but violating its spirit. Third, informal institutions compete with formal ones when formal institutions are ineffective and the two diverge. Finally, informal institutions can substitute for the lack of effectiveness of formal institutions.

The explanation of the above in the scenario of Islam is that first Islam gives the training to the society and then formal rules will only institutionalized the ongoing process into the legal framework. Theoretically what we can say that with this due training of the society one cannot observe many more cases in which formal rules have failed to change informal rules. However, in the conventional societies even Muslims are members of those societies similar formal rules can produce different outcomes because informal rules are not in their true sense following (but not conflicting) the *Shari'ah* rules and regulations. It is worthwhile to note that historically it has been observed that in the Muslim societies that formal rules are have direct conflict with informal rules if those are not formulated under the umbrella of *Shari'ah*. Recent developments in the “religious movement” in the different parts of the Muslim Block is a good example and depicts that how the conflict between formal and informal rules may arise. Currently, most of the Muslim countries followed the rules and regulations of their previous colonial masters. In most of the Muslim states there is a restriction on the religious movements. Consequently the Islamic institutions became (or came to consider itself) the guardian of their customs and traditions. In recent years, many Islamic organizations (especially Islamic movement) have increased their influence in the masses of the Muslim countries and sometimes they worked parallel to their governments. In response to this, authorities of the Muslim states are compelled to implement the Islamic laws even not in their true spirit.

If this does not occur, the Islamic institutions insist on the religious life of the society and consider that the culture of these states will be Westernized or destroyed, which, in the eyes of these institutes, are one and the same thing. The main objective of these organizations is to protect the informal rules of these countries. A very significant question arises that why these institutes got the popularity among the masses? Because individuals sometimes find the costs of

making informal arrangements lower than the costs of depending on formal rules to resolve specific problems (McAdams)<sup>55</sup>. In the true Islamic framework, formal rules and informal rules cooperate with each other. Formal and informal rules can and often do coexist in harmony. Such formal rules are sustainable at low monitoring and enforcement costs. Some examples of formal rules are those that protect one's religious belief, one's reputation, one's life and property, and so forth which are the basic norm of Islamic system.

### **3.2 The Interaction Thesis**

Pejovich (1999) analyzed and suggested that

"(1) institutions develop their own incentives and transaction costs;

(2) institutions and economic outcomes are linked through the effects of the former on incentives and transaction costs; and

(3) informal and formal rules change because some specific individuals and/or organized groups perceive that their benefits exceed the costs of institutional restructuring.

The interaction thesis, which is stated in the following paragraph, derives from those three propositions: If changes in formal rules are in harmony with the prevailing informal rules, the interaction of their incentives will tend to reduce transaction costs in the community (that is, the cost of making an exchange and the cost of maintaining and protecting the institutional structure) and clear up resources for the production of wealth. When new formal rules conflict with the prevailing informal rules, the interaction of their incentives will tend to raise transaction costs and reduce the production of wealth in the community."

A number of examples can be seen in the real world related to the conflict and cooperation among the informal and formal rules. But most of them are not on the ethical grounds. For example prohibition laws in the United States clearly conflicted with the country's prevailing tradition of social drinking. Similarly in the Islamic countries the interest based economy has the conflict with the informal structure of the society or in those Islamic state where drinking is allowed has a more transaction cost. The enforcement of anti-Islamic laws have different transaction costs in the religious and less religious societies respectively. If transaction cost is high than more resources are required for the enforcement of the specific laws. Due to the high transaction cost most of the countries tried to minimize the difference between formal and informal rules/institutes.

Owing to the conflict in between the formal and informal institutions in most of the Muslim states economies paid a very high transaction cost and consequently it has a negative impact on the growth and development of the states. Apparently Muslim countries have observed this cost

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<sup>55</sup>At the time of Mughal regime in India there were not too much dispute which were solved through the legal process. Only the Panchait system were involved in the solution of the disputes among the different members of the society. It is also worth to mention that the number of disputes were very negligible. See also Lisa Bsernstien, Robert Ellickson,

more than the rest of the world. The current protest and rallies in the Muslim states against the sitting regimes is the result of the conflict between the formal and informal rules.

Pejovich (1999) has the opinion that for the verification of the interaction thesis, however, requires more than casual observations. It requires analysis of (a) the process for making rules, (b) the rule makers' incentives, and (c) the effects of those incentives on transaction costs.

### 3.3 Rule-Making: Informal Institutions

Islam is a religion which is very close to the nature. In the Islamic society all the informal institutions must not be conflicted with the *Shari'ah*.

As Pejovich (1999) states, "those (human) interactions that had passed the survival test were institutionalized into taboos, traditions, moral values, beliefs, and so forth.....They change primarily through their erosion, which is a slow and time-consuming process."

However this is partially true for the Islamic society because whatever the situation and how many number of times these human interactions are going to be repeated that will not be institutionalized until and unless it will pass the survival test by the *Shari'ah*. It has been observed that transformation of Islamic communities into the western state could have a high transaction cost. Islam refutes this idea that social stability brings the economic stagnation. The main feature of the Islamic institutions (formal or informal) is that they work under the umbrella of *Shari'ah*. . Whatever the economic consequences if any institute which has the conflict with *Shar'ah* is considered as sub-marginal. And eventually these are not able to become marginal even at the high degree of repeated and human interaction.

In reality that conflict which we have seen in the present state of the Muslim countries in between informal and formal rules, new formal rules ended up replacing the Islamic ethos with political corruption, social instability, and economic failures, for example the Muslim states of Africa and South Asia<sup>56</sup>. After reviewing the Islamic history, we can find a number of events when there is no conflict in between informal and formal rules and that particular event has a very positive effect on the social and economic stability. One of the greatest example is the system of Brotherhood which was established after the migration of prophet (SAW) from Mecca.

### 3.4 Rule-Making: Formal Institutions

Formal rules are enacted, changed, and enforced by legislators, judges, bureaucrats, and other rule-makers. That is, formal rules are a policy variable. New formal rules may emerge in response to the requirements of the game, or rule-makers could pass new rules in order to change the game (Pejovich 1999). In the Islamic system the rules are given, i.e., *Qur'an* and *Sunn'ah*. At his last Haj sermon Prophet (SAW) said that I am leaving behind *Qur'an* and my *Sunn'ah*. Keep them firmly in your hands and this is the only way to get the success in both of our lives. All these rules which are based on *Qur'an* and *Sunn'ah* are without any timer zone. These are forever

<sup>56</sup> Transparency International (2010). "Corruption Perceptions Index". *Transparency International*. Transparency International. [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi](http://www.transparency.org/policy_research/surveys_indices/cpi). Retrieved 24 August 2011

and long lasting. These are according to the nature of the human being and it has the net benefit for the humanity. There is also an institution of *Ijtehad* which is composed of the well established Muslim Scholars and they can change some formal rules according to the need of the time but these changes should be within the Islamic jurisdiction. However, the changes from without the Islamic jurisdiction is not allowed and even not acceptable by the Islamic community. Muslims can exploit the new opportunities and can seek new contractual arrangements if they pass the test from *Shar'ah*. Changes within the Islamic jurisdiction have the lower transaction cost whereas without it has higher transaction cost. As Pejovich (1999) said however, if that rule is out of harmony with informal institutions, people will view it with apprehension, uneasiness, and even outright hostility. Which we have seen in most of the Islamic states. Because these formal rules are not compatible with the informal institutions so the communities are becoming dissatisfied and feeling uneasiness. However, it is not possible to make the drastic changes in the formal rules. If it happens it will create a disaster in the society and economy. The stability of the society and economy is not dependent on the spontaneous change. However, in most of the Islamic states a number of formal rules are not appropriate to the *Qur'an* and *Sunn'ah*. For example family law in Pakistan which was enacted in 60's was not according to the *Qur'an* and *Sunn'ah* so that was completely rejected by the community. This law was out of harmony with informal institutions, people viewed it with apprehension, uneasiness, and even outright hostility. So a high transaction cost was emerged and ultimately it was the one of the basic cause for the removal of the regime of President Muhammad Ayub Khan. This was not the only output of this law but also has the negative impact on the economic growth and development and even that growth which was achieved during last two decades had been washed. In most of the times in Pakistan the higher costs of the formal forced public-policy makers to pass clarifying rules and regulations (hereafter: secondary laws), which attempt to harmonize basic formal rules with prevailing customs, traditions, and moral values, or instead to clear the way for their enforcement. In seventies a slogan of Islamic Socialism in Pakistan, ban on the alcohol drinking and the weekly day off on Friday are a clear-cut examples of this phenomenon. Thus, the number of secondary laws that have to be passed in order to clarify and enforce an important formal rule can be taken as a proxy for its effect on transaction costs; that is, the number of secondary laws depends on the reaction of the prevailing informal institutions to the new formal rule (Pejovich 1999).

#### **4. The Interaction Thesis and Muslim States**

After the end of colonial period a number of Muslim countries got the independence. In the broader sense most of the Muslim countries have the same informal rules because religion plays a very important role in the formation of their social structure. Their social structure is approximately similar to each other. However, their formal institutions are not similar it depends upon their previous masters. All of them have followed the rules and regulations which were previously implemented by western masters. Among these states the growth potential is also different. Habits are also considered as the main ingredient of the growth and economic stability. For example some resource rich economies with sufficient resources are not able to develop themselves. May be the one significant reason is the conflict in between their formal and informal rules and institutions. Societies' informal institutions are more towards their religion of Islam whereas the trend of rulers towards the implementations of the western rules and

regulations. Some of them tried to change the *Shari'ah* laws and tried to impose the amended *Shari'ah* laws<sup>57</sup> which were not accepted by the common Muslim communities and consequently it has the negative impact on the economic performance of the country. As all we know that *Shari'ah* rules are not too much flexible. However there is some room for the small modification in the *Shari'ah* laws through the consensus (*Ijtihad*)<sup>58</sup>. However, it is not too much difficult for the Muslim states to change the formal rules which are not compatible with the informal institutions. In most of the Muslim countries the red-tapism is also a major hurdle for the promotion of growth and economic development.

As colonial rule ended, new Muslim states needed stable rules for carrying out interactions among themselves and with the rest of the world. An important question to which we now turn is whether new formal rules in the Muslim countries, as they interacted with the old ethos, created incentives that raised or lowered transaction costs. Informal rules in the Muslim countries are more or less homogenous and they do have many common traits. Conversely these traits are not common with rest of the world. For the Muslim communities religion is the main and major ingredient for the building of the culture and formal rules. The old ethos in the Muslim countries has been largely free of such Western ideas as classical liberalism and methodological individualism. In the Islamic societies most of the cultural norms are similar disregarding the region where they belong. It is also worth to mention that western traditions were not deep rooted even during the colonial period. The prevailing concept of the community has a strong bias toward collectivism and egalitarianism. Individualism is not the common trait even it is not a favorite one. This bias raises the transaction costs of identifying and accepting alternative institutional arrangements. Moreover, the communities in the Muslim Block have developed customs and common values under the periphery of *Shari'ah*. The original ethos in the Muslim countries have a significant clashes with capitalism and westernized culture. On the contrary from the last six decades the governments and the policy makers of the Muslim countries are trying to teach their communities that capitalism (secularism) is not merely an alternative mechanism for the allocation of resources but a way of life in which individuals voluntarily interact with one another. But still forcing Muslim countries to accept the institutions of capitalism is not able to get the success.

## 5. Conclusion

It is concluded from the above discussion that If Muslim states want to achieve the desired growth targets then they have to analyze the informal institution of their communities. Otherwise their formal institutes will remain inefficient, and inefficient institutions may persist if conflict persists in between the formal and informal institutes. It is important to get things right, or as right as possible, the first time around. There is need of time to increase the credibility of these states, and trust is a component of the social capital.

Policies and programs should be designed to promote convergence between formal and informal institutions by identifying and working on the informal aspects of the formal institutions and the

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<sup>57</sup> For example Tunisia, Turkey (A real disaster may happen when states are powerful enough to disrupt an and existing local cooperative status but not capable enough to replace it with anything functional and less arbitrary, (Stiglitz, J.E. 2000, Formal and Informal Institutions, World Bank, 67.)

<sup>58</sup> But not like Tamur Kuran that these *Shari'ah* rules are not suitable for the large group. For more detail discussion on Tamur Kuran See Adnan Almasi

successful of the informal. This would provide the foundation of poverty reduction, wealth creation and human freedom. At the end we can say that Islamic states should think local but act global.

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## **Appendix**

Here we are trying to present two short examples from Pakistan and Turkey. These examples are not giving the full details just give the some glimpses.

### **An example from Pakistan**

After the colonial period most of the political leaders in the Pakistan had the training from the well-recognized western educational institutions, with considerable support from the West, used the strong hand of the state to build capitalism, they basically tried to replace Islamic culture with a western one. The new conflict created an opportunity for two groups, former landlords and the bureaucracy (civil and army) to seek personal gains through the machinery of the state. However, by pursuing their self-interest, those two groups produced some unintended consequences that have affected the character of social, economic, and political life in Pakistan.

#### **Political leaders**

As colonial rule ended in 1947, the political leaders had incentives to seek ways to preserve their power and privileges. To preserve the value of their political power, these landlords, while paying lip service to Islamic reforms, had to maintain or recreate a western system. They knew that this would give them a good chance to stay in power with help of the western powers. Most of them, then, quickly transformed themselves into nationalists. Indeed, most of these leaders in the Pakistan during their early periods were Islamists. Switching to capitalism/secularism was not easy for them because Islamic system has not many common traits. So in 70s the slogan of Islamic Socialism was given to the public. And later on in 80s a dream of Islamic system was given to the Pakistan.

#### **Bureaucracy (Civil and Army)**

Under colonialism, in Pakistan like the other developing countries bureaucracy has a lot of power. They have a lot of benefits and perks. These perks were unique to them. Actually they considered themselves as first graded citizens. These officers assumed the Islamic institutions as a threat to their current and future benefits. They played a collective game with the political leaders for the implementation of the western rules and regulations. Most of the political leaders and officers from the bureaucracy whatever their ideological preference, are hostile to Islamic system for reasons of self-interest. By contrast, young people, who are well educated but fed-up with the current oppressive and corrupt system strongly support the transition to Islamization. So the conflict in between the formal and informal institution could not be able to support the growth of the economy. Economy of Pakistan with a reasonable human and natural resources is not able to achieve the desirable economic growth.

### **An example from Turkey**

Another interesting example is from Turkey. After the second world war the formal institutions have the continuous conflict with the informal rules. Approximately most of the population is Muslim. And have its own religious taboos and ethos. Whereas most of the regimes those ruled this population was secular. Due to his conflict a high transaction costs was observed by the

community and economy. During the last five decades one cannot see any cooperation among the formal and informal rules.

Justice and Development Party (the ruling Party) has felt this conflict and tried to increase the cooperation in between the formal and informal institutes. It is interesting to note that economic statistics are presenting a very good picture of the economy. During this regime the inflation rate has fell down from 45% to 9%, poverty rate has also been significantly reduced, it is also amazing to note that people are ready to pay actual taxes. This is the sign that public has the trust on the current regime. One hundred and fifty six are public universities and their enrollment is sixty to seventy thousand each. This is the state responsibility to provide medical facility who is under eighteen.