

STAKEHOLDERS MODEL OF GOVERNANCE IN ISLAMIC ECONOMIC SYSTEM

**Zamir Iqbal
Abbas Mirakhor¹**

The paper discusses the design of an efficient and optimal corporate governance structure of a firm within the Islamic economic system. The objective of this paper is to identify factors, which will influence corporate governance within an Islamic economic system and to examine if corporate governance model will be 'shareholder'- or 'stakeholder'- cantered? The paper argues that the governance model in Islamic economic system is a stakeholder-oriented model where governance structure and process at system and firm level protect rights of stakeholders who are exposed to any risk as a result of firm's activities. Whereas conventional system is struggling with finding convincing arguments to justify stakeholders' participation in governance, the foundation of a stakeholder model is found in Islam's principles of property rights, commitment to explicit and implicit contractual agreements and implementation of an effective incentive system. The paper also discusses the implication of a stakeholder model on depositors, Islamic financial institutions, and regulators.

1. INTRODUCTION

The issue of corporate governance and search for optimal governance structure has recently received considerable attention in conventional

economic literature and public policy debates. This increased attention can be attributed to several factors such as (a) the growth of institutional investors, i.e. Pension funds, insurance companies, mutual funds and highly leveraged institutions, and the role institutional investors play in the financial sector especially in major industrial economies; (b) widely articulated concerns and criticism that the contemporary monitoring and control of publicly held corporations in Anglo-Saxon countries especially UK and USA are seriously defective, leading to sub-optimal economic and social development,² (c) a shift away from traditional ‘shareholder value centered’ view of corporate governance in favour of a corporate governance structure extended to a wide circle of stakeholders; and (d) impact of increased globalization of financial markets, global trend of deregulation of financial sectors, and liberalization of institutional investors’ activities which have raised concerns over corporate governance.³ Although, each of the above mentioned factors provides compelling reasons to examine current corporate governance structures, the most challenging, and the one which contains the seeds of a paradigm shift in understanding of corporate governance, is the stakeholder-oriented model of governance.

This paper examines the arguments for and against the stakeholder model presented in conventional literature and argues that a stakeholder-oriented theory of corporate governance finds strong roots in the Islamic economic system. Section 2 discusses the stakeholders theory in conventional system and identifies critical issues. Sections 3 and 4 examine the theoretical framework in support of stakeholders theory from Islamic economic system. Section 5 discusses the governance structure in Islamic economic system. Section 6 concludes the discussion.

2. STAKEHOLDER MODEL OF CORPORATE GOVERNANCE

The concept of corporate governance is diverse and, over the period of time, definition of the term 'corporate governance' has oscillated between two extremes-- from a narrow concept of a mechanism of implementing investors' interest to a broad concept advocating protection of all internal and external stakeholders' rights. This wide spectrum of concept stems out of two divergent views: (a) how the entity of a 'firm' should be perceived in an economic system, and (b) the form of the incentive system to protect rights and to preserve the obligations of economic agents in the environment in which the firm operates. Whether one views the firm as a bundle of assets and liabilities, a legal entity, an economic or social organization, a nexus of contracts, or as a combination of these elements, will influence the way in which the evolution of conceptualization of corporate governance is analyzed.⁴

The modern theory of firm dates to Coase's (1937) fundamental insight that firms exist as a substitute for more costly modes of transacting. Transaction costs in negotiating, contracting, coordinating, enforcing and discharging rights and obligations under a set of contracts can be reduced by creating a firm that serves as an intermediary between the consumer and the supplier of inputs.⁵ Based on Coase's idea of transaction costs as an explanation for the existence of a firm, Alchian and Demsetz (1972) further refined the idea and viewed the firm through agency-cost theory and focused on the cost of monitoring. They considered management of the firm to be a 'continuing process of negotiation of successive contracts.' Jensen and Meckling (1976), developed the notion of the firm as nexus of contracts, and argued that contractual designs emerge to minimize transaction costs between specialized factors of production. Focus of early

researchers was to identify ways in which managers could be made responsive to shareholders despite the dispersed nature of share ownership.

This basic agency problem suggests a possible definition of corporate governance as that which constitutes an efficient monitoring structure solving both adverse selection and the moral hazard problems. Shleifer and Vishny's (1997) survey of corporate governance is focused on this view of corporate governance restricted to the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment. Corporate governance structure, focused on investor-manager contract and relation, is often referred to 'shareholder model' of corporate governance. It can be characterized as a model where (1) shareholders ought to have control, (2) managers have a fiduciary duty to serve shareholder interests alone, and (3) the objective of the firm ought to be the maximization of the shareholders' wealth.

Traditional definition of corporate governance among economist and legal scholars, based on agency relationship between the investor and the manager, is concerned with the protection of shareholders' or investors' interests only. Business ethicists have generally considered this result to be ethically unacceptable because it unjustifiably neglects the rights of non-shareholder groups. Opponents of shareholder-value concept point out that this profit-maximization approach to the firm is too narrow a view for an economic analysis of corporate governance because of externalities imposed by profit maximization choices on other stakeholders. These include, *inter alia*, constraints on welfare of management and workers who have invested their human capital as well as off-work related capital (housing, spouse employment, schools, social relationships, etc.) in the employment relationship and on suppliers and customers who have also sunk investments

in the relationship and foregone alternative opportunities, and on communities who suffer from the closure of business.⁶ The exclusion of the interests of the others involved in the firm affirms a divisiveness that could well be consequentially counter-productive.⁷

The neo-institutional economists⁸ argue that the firm's claimants go beyond shareholders and bondholders to include others with whom the firm has any explicit and implicit contractual interaction. In this '*nexus-of-contracts*' view, each corporate constituency, including employees, customers, suppliers, and investors, provide some asset in return for some gain. Contracts result from bargaining by these constituencies over the terms of their compensation as well as the institutional arrangements that protect this compensation from post-contractual expropriation.⁹ According to this view, there is nothing unique to corporate governance, which simply becomes a more complex version of standard contractual governance.¹⁰ All stakeholders are regarded as contractors with the firm, with their rights determined through bargaining.

Stakeholder theorists reject the three main propositions of the shareholder system and argue for the following: (1) all stakeholders have a right to participate in corporate decisions that affect them, (2) managers have a fiduciary duty to serve the interests of all stakeholder groups, and (3) the objective of the firm ought to be the promotion of the interests of all and not only those of shareholders. This view is commonly referred to as 'stakeholders' model of corporate governance where 'stakeholders' may include customers, suppliers, providers of complementary services and products, distributors, and employees. Therefore, this theory holds that corporations ought to be managed for the benefit of all who have some stake in the firm.¹¹

A critical review of evolving literature dealing with stakeholders reveals that the concepts of stakeholder, stakeholder model, stakeholder theory, stakeholder management, and stakeholder society are explained and used by various authors in very different ways and supported (or critiqued) with diverse and often contradictory evidence and arguments.¹² Tirole (1999) suggests that there is little formal analysis of the economics of stakeholder model or stakeholder society. Stakeholder model is largely normative and is still evolving to find a sound theoretical foundation in conventional economic literature. In this process, a number of issues have to be addressed. First, it is argued that ‘nexus-of-contracts’ view of the firm needs to expand the concepts of contracting and agency beyond their narrow use in economics and include their legal and moral uses in order to make stakeholders theory of governance a comprehensive one.¹³ Distinction between explicit (or formal) and implicit (or relational or self-enforcing) contracts and claims is key concept in understanding the foundation of stakeholder model.¹⁴ When it is difficult to write complete state-contingent contracts – when, for example, certain variables are either ex-ante unspecifiable or ex-post unverifiable – people often rely on ‘unwritten codes of conduct’, that is, on *implicit contracts*.¹⁵ These may be self-enforcing, in the sense that each party lives up to the other party’s (reasonable) expectations due to fear of retaliation and breakdown of cooperation.¹⁶ This implies that, in addition to obligation on explicit contracts, obligations arising out of implicit contracts have to be incorporated into the ‘*nexus of contracts*’ theory with convincing arguments, and that can only be articulated by expanding the scope of analysis to include ethics, morals and social order. Hart (2001) forcefully argues that many economic transactions are sustained by self-enforcing (‘implicit’) contracts or norms of behaviour,

such as honesty or trust; concepts which so far have proved difficult to formalize in economic theory.

Second issue is how to draw a line of distinction between a stakeholder and a non-stakeholder. Existence of a stakeholder entity and its rights are easy to recognize, but question still remains who really qualifies as an actual stakeholder? Third issue deals with the stakeholders' right to influence management decision-making or to participate in governance of the firm. Questions arise why stakeholders should be given such right and why managers should have a fiduciary duty to protect rights of non-investor or non-owner stakeholders if such stakeholders have protected their rights through bargaining in the terms of the contracts. Whereas there appears to be a consensus on identifying the rights of non-owner stakeholders and an implicit agreement to protect these rights, there is still a debate on why such stakeholders should participate in the control and management processes of a firm. For example, the notion that property rights are embedded in human rights and that restrictions against harmful uses are intrinsic to the property rights concept clearly highlights the interests of other non-owner stakeholders but it remains unclear which uses of property should be restricted and which persons should count as stakeholders. Simply bringing non-owner stakeholders into the conception of property rights does not, provide by itself, a justification for assigning any specific groups of stakeholders, such as employees and customers, managerial responsibilities.¹⁷ So far, discussions of stakeholder model have not been able to articulate a convincing argument on either theoretical, moral, or legal grounds to recognize active role of stakeholders in management and control of a firm.

In considering an Islamic view of the role of stakeholders, it is noted that two fundamental concepts of Islamic economic system pertaining to property rights and contracts govern the economic and social behaviour of individuals, society and state. These two principles also dictate objective function of economic agents, including legal entities like firms. A firm in Islamic economic system can be viewed as ‘nexus-of-contracts’ whose objective is to minimize transaction cost to maximize profits and returns to investors subject to constraints that these objectives do not violate property rights of any party whether it interacts with the firm directly or indirectly. In pursuit of these goals, firm honours its obligations to explicit and implicit contracts without impinging on the social order. This definition incorporates stakeholders’ role in its view of the firm and supports recognition and protection of their rights. A discussion of Islam’s principles of property rights and contracts in Sections 3 and 4 provides a foundation for this proposition and also clarifies issues, which the conventional stakeholder theory has yet to resolve.

3. PROPERTY RIGHTS AND GOVERNANCE

The design of governance system in Islam can be best understood in light of principles governing the rights of individual, society, and state, the laws governing property ownership, and the framework of contracts. Islam’s recognition and protection of rights is not limited to human beings only but encompasses all forms of life as well as the environment. Each element of Allah (S.W.T)’s creation has been endowed with certain rights and each is obligated to respect and honour the rights of others. These rights are bundled with the responsibilities for which humans are held accountable.¹⁸ *Shari’ah* offers a comprehensive framework to identify, recognize, respect

and protect rights of every individual in creation, community, society, and the state. Islamic scholars and *fuqahā'* have defined and codified detailed principles identifying these rights.¹⁹ The importance of being conscious and mindful of the rights of others (including stakeholders – human or non-human) and the significance of discharging the responsibilities associated with such rights is reflected by the following saying of the Prophet (pbuh):²⁰

‘So give to everyone who possesses a right, his right.

The term *ḥaqq* (right) denotes something that can be justly claimed, or the interests and claims that people may have been granted by *Shari'ah*. Majority of *Shari'ah* scholars and jurists hold that similar to a physical property, rights are also property (*al-māl*) because, like physical property which has beneficial uses and is possessable, rights have beneficial uses and are regarded as capable of being possessed.²¹ Rules defining the property rights in Islam deal with the rights of ownership, acquisition, usage and disposition of the property. Any violation of these rules is considered a transgression and leads to disruption in social order.

The notion of ownership in Islam is two-tiered: (i) real and absolute, and (ii) delegated and restricted through time-bound possession. The former belongs to Allah (S.W.T) only because He is the ultimate creator while the latter is reserved for the man in order that he becomes materially able to perform his duties and obligations. Therefore, the first axiom of the property rights in Islam is that Allah (S.W.T)-- the real owner, creator, and benefactor – reserves the right to prescribe for man – His vicegerent, recipient and possessor-owner – rules governing the property while it is in the temporal possession of man.²² Ownership rights in Islam originate from the concept of *khilāfah* (stewardship) as the Qur'ān and *sunnah* clearly and explicitly state that Allah (S.W.T) is the sole owner of property and that

man as vicegerent of Allah (S.W.T) is merely trustee and custodian.²³ This relationship implies that man has the right to use and manage his 'private property' in a manner similar to that of a custodian and trustee. Property is not an end itself, but a means to discharge effectively man's responsibilities as the vicegerent of Allah (S.W.T).

The second axiom of property rights in Islam is that this right of possession is a collective right and individuals can only earn a priority in the use of these resources.²⁴ While a part of these resources are reserved for the exclusive possession of the collectivity, the remaining part is allowed to be owned by individuals without the collectivity losing its initial right of possession to these resources. However, when an individual applies his creative labour to these resources he gains a right of priority in the use and enjoyment of the resulting product, without the rights of others being nullified. Individuals are to use these resources with the full understanding that Allah (S.W.T)'s ultimate ownership and the collectivity's prior right, remain intact. This notion is the result of the permanence, constant, and invariant ownership of Allah (S.W.T) of all the resources, and by implications, that of prior right to these resources by the collectivity.²⁵ This proposition becomes a legislative basis for requiring preservation of society's well-being and interests.

Social interest and the collective dimensions of human life demands that individual freedom is kept within certain limits and a balance is created such that the individual, the society, and the state each has a claim on property rights in respect of the roles assigned to them. Property rights of these three agents should not come into conflict with one another, nor should the exercise of those rights by any one of these agents jeopardize the exercise of rights by the others.²⁶ If as a result of the growth of the society, division of

labour, or increasing complexities of markets, either the obligation to share is shirked or the rights of the society and the cohesion of the community are undermined, or a harmonious social order is at stake, the justification is created for the intervention of the legitimate authority to take corrective measures.

Second axiom of the property rights implies that while individual's possession of these resources and his share in the outcome is allowed, sanctioned and protected by the *Shari'ah*, it is so as long as it does not come into conflict with society's interest and well being. Hence, private initiative and choice are recognized, but such recognition is not allowed to subvert the principle of sharing or lead to violation of the rights of the society and the state.²⁷ However, once the individuals have discharged their duties to the society and the state, in accordance with prescribed manner and amount, and are not in violation of the rules of *Shari'ah*, their right to their possessions is held inviolate and no one has a right to force appropriation (or expropriation) of that person's property to anyone else.²⁸ This is further endorsed by a *hadith* stating that '*Muslims' blood, property and dignity are protected against each other.*'²⁹

Ibn Taimiyah views property as a right granted by *Shari'ah* to utilize an object but a right of varying kinds and degrees. Sometimes the right is an extended one so that the proprietor can sell or give away the object, lend it or make a gift of it, bequeath it or use it for productive purposes; but sometimes the right is incomplete, and therefore the proprietor's rights are limited or restricted.³⁰ Rules concerning property acquisition, possession, usage and disposal should be looked at as regulations rather than the restrictions.³¹ Basic conditions to maintain lawful rights 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.³² Islam places great emphasis on acquiring and maintaining rights to property through lawful means but does not impose any limits on the amount of the property owned, i.e. Imposition of any cap on the amount of wealth an individual can accumulate as long as the individual is conforming to the obligations set by *Shari'ah*.³³

Islam recognizes two ways in which an individual can obtain rights to property: (1) through his own creative labour and/or (2) through transfer – via exchange, contract, grants or inheritance – of property rights from another individual who has gained title to the property or asset through his own labour. Property acquired through non-permissible and unjustifiable means like gambling (*maysir*), bribing, stealing, cheating, forgery, coercion, or illegal trading does not qualify as '*al-māl*' as defined by *Shari'ah* and therefore is proscribed and forbidden. Consequently, any property, which is considered counter-productive or non-beneficial, loses its legitimacy and its associated rights. Hoarding with the intention to creating artificial scarcity and profiteering is considered unacceptable means of building wealth and property. Similarly, property acquired through breach of trust, adulteration, non-compliance with weights and measures, or unethical means does not satisfy the definition of property (*al-māl*) and therefore its ownership is not considered legitimate.

Concomitant with property rights, the *Shari'ah* imposes responsibilities, among which are the obligations-- severely incumbent upon the individual-- not to waste, destroy, squander, or to use the property for purposes not permitted by the *Shari'ah*.³⁴ To do so would be to transgress the limits set

on one's right and an encroachment on the rights of the others. The right of the collectivity to the property is further protected by the *Sharī'ah* through the limitations imposed on the right of disposition of the property by the person who has gained priority in the use and enjoyment of that property. Hence, while the right of use and enjoyment of the property is affirmed by the *Sharī'ah*, the exclusive and absolute right of disposition of the property is rejected.³⁵ The prohibition of *isrāf* and *tabdhīr* (wasting and squandering) in all areas applies to property as well. The individual may not make an alteration in his property that may harm even his neighbour. If the property owner proves his inability to use the property properly (within boundaries defined by *Sharī'ah*), he forfeits his ownership rights. Under such conditions, the legitimate authority is fully justified in withdrawing the rights of usage of that property in order to protect it from the misuses by the owner.³⁶ This position of the *Sharī'ah* is in conformity with the Islamic conception of justice (*al-ʿadl* and *al-iḥsān*) and the rights and responsibilities of the individual and the community.

Islam's concept of property rights differs in many aspects from the concept of property rights in other economic systems. On one extreme, proponents of market-based system argue in favour of individual-centred private property rights as fundamental right while on the other extreme a small minority believes that private property right is fundamentally immoral.³⁷ On the contrary, Islam promotes a balance among rights of individuals, society and the state. This concept sharply contrasts with the self-centred utility maximizer economic agent idealized in neoclassical economics in an unbounded, insatiable, quest for acquisition and accumulation.³⁸ Before the full market society came to prevail in the West, a great deal of property right in land and other assets was a right to use and

enjoy the asset but not a right to dispose of it.³⁹ The development of full market society required revision of this notion of property since it was considered that the right not to be excluded from the use or enjoyment of something that is not marketable. It was deemed impossible to reconcile this particular right with a full market economy. Hence, of the two earlier kinds of property rights—the right to exclude others and the right not to be excluded by others—the second was all but abandoned and the conception of property rights was narrowed to cover only the right to exclude others. In Islam, however, this right is preserved without in any way diminishing the role of the market as resource allocative and an impulse-transmitting mechanism. Islam does not endorse the notion of conventional system that a person does no harm to members of his group if as a result of his effort he is better off and others are no worse off than they would otherwise be.

Several conclusions can be drawn from the preceding discussion. First, Islam's concept of property rights is different such that the individual has a delegated right on the property whose acquisition, usage and disposal are subject to rules including the principle of sharing as dictated by *Shari'ah*. Second, whereas Islam strongly recognizes individual's private property rights, these rights are governed by rules designed to protect the rights of society and the state. Third, by virtue of the first and second axiom of property rights, every individual, group, community, society and the state becomes a stakeholder whose rights are granted and preserved by *Shari'ah* to promote social order and economic development. Fourth, whereas it is difficult to recognize or justify some rights of others in a formal economic theory in the conventional system without drawing any reference to ethics and morality, such problem does not exist in Islam where everyone's rights are recognized and protected by Law (*Shari'ah*). Finally, inclusion (or

exclusion) and recognition (or denial) of rights of stakeholders in Islamic economic system are based on foundations of rules and laws, which need no justification merely on the grounds of morality alone but are derived from principles aimed at creating a just and balance in economic and social system.

Whereas *Shari'ah* guarantees some basic property rights to individuals by virtue of them being members of the society, rights of a firm or a legal entity like corporation are earned and acquired. It is not the firm, which accrues property rights but it is the property acquired in course of the firm's economic activity that has property rights and claims. Once a property is earned or acquired by the firm, it is subject to the same rules of sharing and prohibition of wasting which apply to property of individuals. Firm's property rights also come with similar claims and responsibilities as individuals. This implies that firm is expected to preserve property rights of not only local community or society but also of those who have participated in the process of acquiring or earning the firm's property. No action of the firm that violates basic set of property rights of those with whom firm interacts will be acceptable.

Principles of property rights in Islam clearly justify inclusion of stakeholders into decision-making and accountability of an economic agent's activities. This inclusion is based on the principles 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 violation of property rights, and finally (d) any property leading to the denial of any valid claim or right would not qualify

to be recognized ‘*al-māl*’ and therefore will be considered unlawful according to *Shari‘ah*.

4. CONTRACTS AND GOVERNANCE

The significance of contractual obligations in economic and social relations cannot be over-emphasized. The whole fabric of Divine Law is contractual in its conceptualization, content, and application. Islam forcefully places all economic relations on the firm footing of ‘contracts.’⁴⁰ It recognizes only one status, i.e. Moral consciousness and virtue, all other status on any basis is obliterated. The very foundation of the *Shari‘ah* is covenant between Allah (S.W.T) and man; this imposes on man the duty of being faithful to his word. On Allah’s side, the Qur’ān often states that ‘*Allah will not fail in His promise.*’⁴¹ On man’s side, his commitment to the contractual obligations is considered the best form of honouring his acceptance of Allah (S.W.T) as his Lord.

A contract in Islam is a time-bound instrument, which stipulates the obligations that each party is expected to fulfil in order to achieve the objective(s) of the contract. Contracts are considered binding and their terms are protected by the *Shari‘ah*, no less securely than the institution of property. The freedom to enter into contracts and the obligation to remain faithful to their stipulations has been so emphasized in Islam that a characteristic, which distinguishes a Muslim, is considered to be his faithfulness to the terms of his contracts. In the *Shari‘ah*, the concept of justice, faithfulness (called *amānah*, whose antonym is *khiyānah* meaning betrayal, faithlessness and treachery), reward and punishment are linked with the fulfilment of obligations incurred under the stipulation of the contract.

The *Sharī'ah* judges the virtue of justice in man not only for his material fulfilment of contracts but also by the essential attribute of his forthright intention (*niyyah*) with which he enters into every contract. This intention consists of sincerity, truthfulness, and insistence on rigorous and loyal fulfilment of what he/she has consented to do (or not to do). This faithfulness to one's contractual obligations is so central to Islamic belief that when the Prophet was asked 'who is a believer?' He replied that '*a believer is a person in whom the people can trust their person and possessions.*'⁴² In a very terse, direct and forceful verse, the Qur'ān exhorts '*O you who believe, fulfil contracts.*'⁴³ So basic is the notion of contracts in Islam that every public office is regarded, primarily as a contract and agreement, which defines the rights, and obligations of the parties.⁴⁴

Implication of the emphasis placed on contracts in Islam is that it makes the members of the society and economic agents aware of the obligations arising from their contractual agreements-- verbal or written, explicit or implicit. In case of explicit contracts, parties to the contract clearly stipulate expected behaviour and duties with respect to the terms of the contract. This contract is to be free of information asymmetry; parties intend to comply with the terms of the contract and are fully aware of rights and obligations. Importantly, the state ensures enforceability of the contract in case of violations by either party. On the other hand, implicit contracts are not formal contracts with clearly defined terms but are claims and obligations that come with the rights to be part of a society.⁴⁵ Principles of sharing and rights of collectivity to property rights are kind of implicit contracts to preserve and protect rights of others and thus establish a wide spectrum of implicit obligations.⁴⁶ Within property rights framework, one has contractual obligations to others including the community and the society according to

the rules of *Shari'ah*, and honouring of this obligation is considered a sacred duty. This sacred duty to preserve property rights of others is moral, social and legal foundation for recognizing and enforcing obligations to implicit contracts.

Islam's framework of contracts places equal emphasis on obligations arising from both explicit and implicit contracts. This behaviour is expected from individuals as well as from public and private entities. Therefore, just as it is incumbent upon economic agents to honour explicit contracts, it is obligatory on them to preserve sanctity of implicit contracts by recognizing and protecting property rights of stakeholders, community, society and state. Whereas conventional stakeholders' theory is searching for sound arguments to incorporate implicit contracts in the theory of firm, in Islamic economic system rights of and obligations to stakeholders are taken for granted.

Islam's framework of property rights and contracts also establish guidelines regarding who can qualify as a stakeholder and if such stakeholder has right to influence the firm's decision-making and governance. In a very broad sense, any group or individuals with whom firm has any explicit or implicit contractual obligations qualify as a stakeholder even though firm may have formal contracts with them through mutual bargaining. In Islam, a stakeholder is the one whose property rights are *at stake* or *at risk* due to voluntary or involuntary actions of the firm. In case someone's rights are encroached or threatened as a result of firm's operations, that individual, group, community or society becomes a stakeholder.⁴⁷ This risk-based definition of stakeholder is supported by a saying of Prophet that '*a Muslim is the one from whose hand others are safe.*'⁴⁸

Having established the firm's responsibility to society and stakeholders, question still remains whether stakeholders have the right of participation in decision-making. Or, if they are given right to participate, is it practical and operationally efficient? These issues are discussed in detail in the following section.

5. CORPORATE GOVERNANCE STRUCTURE

Once the rights of stakeholders are recognized, one can focus on what determines the best institutional arrangements to protect the stakeholders' rights to its true spirit. Or what structure of governance can yield optimal results. Within the conventional stakeholder theory, there are opposing arguments with regards to stakeholders' participation in the governance. Some argue that there is greater need that a firm should internalize the externalities on the various stakeholders and this internalization should be in form of active participation in the process and structure of corporate governance.⁴⁹ Others argue that each stakeholder or constituency is free to bargain with a firm and to choose the most effective means for protecting its interests. Some stakeholders may derive little benefit from the set of rights negotiated by shareholders and therefore would prefer other safeguards for their interests. Consumers, for example, instead of seeking a seat on the board of directors, or the benefit of fiduciary duties may settle for manufacturers' warranties, consumer and product safety laws, and tort liability system because these protections better serve their interests.⁵⁰

Islamic economic system is a rule-based incentive system; based on the rules of *Shari'ah* with the ultimate goal of maintaining a just and harmonious social order. Rules are restrictions on what the members may do without upsetting the social order on whose existence all members count in

deciding on their individual choices and actions. Therefore, attachment to and observance of rules will guide the members of the society in their actions. The rules themselves are composed of those which deal with the individual's body and his state of consciousness, those which govern his relationships with other members of the society, those which guide his relationship with the collectivity and finally those which constitute the code of conduct necessary for the community as a whole. Rules serve to prevent conflicts, reconcile the different purposes of many individuals and facilitate cooperation among them. If as a result of growth of the society, division of labour, or increasing complexities of markets, either the obligation to contracts or property rights are shirked or the rights of the society and the cohesion of the community are undermined, justification is created for intervention of the legitimate authority to take corrective measures.⁵¹ Compliance with them promotes social integration and unity and preserves the intended social order.

In Islam, expected behaviour of a firm would not be any different from the expected behaviour of any other member of the society. Since firm itself does not have a conscious, behaviour of its managers becomes the behaviour of the firm and their actions are subject to the same high standards of moral and ethical commitment expected from a Muslim. In other words, firm's economic and moral behaviour is shaped by its managers acting on behalf of the owners and it becomes their fiduciary duty to manage the firm as a trust for all the stakeholders and not for the owners alone. Consequently, it will be incumbent upon managers to ensure that behaviour of the firm conforms to the principles and the rules of *Shari'ah*. If there is any deviation, institutional arrangement discourage such deviation. In an ideal situation where all agents are true and practicing Muslims, whose

behaviour correspond fully to the requirement of the *Shari'ah*, the faithfulness to the terms of contracts and accountability to respect others' property rights will lead to elimination of problems due to asymmetric information, moral hazard and adverse selection and thus would guarantee optimal governance. In a less perfect world where commitment to contracts may be influenced by personal interests at the cost of interests of collectivity to induce deviation from the terms of contract, design of a governance structure will be required to ensure faithfulness to agent's contractual agreements and protections of everyone's rights.

The design of a corporate governance system in Islamic economic system entails implementation of a rule-based incentive system such that the compliance with the rules ensures an efficient governance system to preserve social justice and order among all members of society.⁵² This would imply the design of institutions and rules that induce or, if needed, compel managers to internalize the welfare of all stakeholders. The rights that are claimed for stakeholders are not ends in themselves-- which ought to be recognized in any form of economic organization-- but means for protecting constituency rights.⁵³ In an Islamic system the observance of rules of behaviour guarantee internationalization of stakeholder rights (including those of the society at large). No other institutional structure would be needed if there were complete adherence to Islamic rules. However, to ensure compliance to the Islamic rules, there is need for institutional arrangements. Therefore, it would be the Islamic government that should specify appropriate corporate governance structure, 'incorporating all stakeholders' rights into fiduciary duties of managers' of the firm on behalf of non-investors or stakeholders. So no other institutional arrangement that would allow individual non-investor stakeholders to

negotiate directly with the firm would be necessary. Incorporating all stakeholders' right into fiduciary duties of managers would be counter-productive and would lead to sub-optimal results. The important point is that each stakeholder is given freedom of bargaining to protect its rights and there are systematic institutional arrangements in place to provide protection and to mediate where disputes and disagreements arise.

Institutional arrangements can be part of system-wide infrastructure surrounding the governance structure of the firm. For example, because contracts are invariably incomplete, judicial interpretations can fill in the gaps. It is permissible to regard employment law, consumer law, tort law, as well as judicial rulings and administrative regulations, as part of the contracts that various stakeholders have with the firm.⁵⁴ Similarly, the concept of *Shari'ah* boards is very unique to Islamic financial system. A *Shari'ah* board, consisting of *fuqahā'* (scholars in *Shari'ah* matters) has been used to oversee the operation of a financial institution to ensure that the operations and code of conduct of Islamic bank is according to the rules of *Shari'ah*. A *Shari'ah* board for every firm, which is seen in present architecture of Islamic banking, is not efficient whereas only one set of rules is needed for appropriate corporate governance based on the *Shari'ah* for all firms. The same idea of *Shari'ah* board can be extended to a system-level board consisting of scholars from different disciplines including *Shari'ah*, economics, finance, and commercial law, to ensure that rules are defined and enforced so that economic agents fully comply with contractual obligations to all the stakeholders.

6. CONCLUSION

This paper examines the conventional stakeholder theory of corporate governance, which views a firm as a ‘nexus-of-contracts’ with different stakeholders and argues that firm’s objective should be to maximize welfare of all stakeholders. This theory has yet to offer strong arguments with regards to who is a stakeholder and why firm has any obligation to non-owner stakeholders because of absence of theoretical foundation to incorporate morals, ethics and trust in the economic theory. This paper argues that the principles of property rights and contracts in Islam offer theoretical foundations to acknowledge the rights of all stakeholders.

Islam’s principles of property rights, contracts, and just social order define the business environment where economic agents are morally conscious of protecting property rights and contractual obligations to each other whether acting as managers, employees, suppliers, customers, or in any other capacity. All participants in economic activities, whether individuals, firms, corporations, non-profit organization or public institutions, are subject to the same degree of commitment. Notion of sanctity of contractual obligations is not limited to explicit contracts, which are well defined, stipulated and documented, but is equally applicable to implicit contracts, which are incomplete in nature. Property rights of all contractual parties, i.e. Individuals, or local communities, or intangible legal entities, or the society are preserved and protected. Keeping in mind that voluntary behaviour of all economic agents may deviate from the expected behaviour, implementation of an incentive system according to the guidelines of *Shari^hah* will ensure that all economic activities adhere to *Shari^hah* principles of property rights and contracts so that an optimal social order is achieved. It is not necessary for each stakeholder to be a participant

in the decision-making as long as their rights are protected through sound institutional arrangements.

References

- Ahmad, Mushtaq (1995), *Business Ethics in Islam*, Islamabad, Pakistan: The International Institute of Islamic Thought.
- Alchian, A. And H. Demsetz (1972), 'Production, Information Costs, and Economic Organization,' *American Economic Review* (December), 777-795.
- Ali ibn al-Husayn, Imam Zayn al-Abidin (1990), *Risālat Al-ḥuqūq* (trans.), William C. Chittick, *The Treatise on Rights*, Qum, Iran: Foundation of Islamic Cultural Propagation in the World.
- Balling, M., E. Hennessy, and Richard O'Brien (1998), *Corporate Governance, Financial Markets and Global Convergence*, London: Kluwer Academic Publishers.
- Bashir, Abdel-Hameed M. (1999), 'Property Rights in Islam', *Conference Proceedings of the Third Harvard University Forum on Islamic Finance*, Cambridge, MA, USA: Harvard University (October), 71-82.
- Baums, T., R. M. Buxbaum and K. J. Hopt (1994), *Institutional Investors and Corporate Governance*, New York, USA: Walter de Gruyter.
- Behishti, Muhammad H. And Javad Bahonar (1990), *Philosophy of Islam*, Karachi, Pakistan: Islamic Seminary of Pakistan.
- Berle, A. A. And G. C. Means (1932), *The Modern Corporation and Private Property*, New York, USA: Macmillan.
- Blair, M. M. (1995), 'Corporate 'Ownership'', *The Brookings Review*, **15** (2), 16-19.
- Bloomstein, H. J. (1998), 'The New Financial Landscape and its Impact on Corporate Governance,' in M. Balling et al. (eds), *Corporate*

- Governance, Financial Markets and Global Convergence*, London, UK: Kluwer Academic Publishers.
- Boatright, John R. (2002), 'Contractors as Stakeholders: Reconciling Stakeholder Theory with the Nexus-of-Contracts Firm', *Journal of Banking and Finance*, **26**(9), 1837-52.
- Clarkson, M. B. E. (1995), 'A Stakeholder Framework for Analyzing and Evaluating Corporations', *The Academy of Management Review*.
- Coase, R. H. (1937), 'The Nature of the Firm,' *Economica*, **IV** (16), 386-405.
- Cornell, B. and A. C. Shapiro (1987), 'Corporate Stakeholders and Corporate Finance,' *Financial Management* (Spring).
- Donaldson, T. (1989), *The Ethics of International Business*, New York, USA: Oxford University Press.
- Donaldson, T. and L. E. Preston (1995), 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications,' *Academy of Management Review*, **20** (1), 65-91.
- Foss, Nicolai J., Lando Henrik and Steen Thomsen (1998), 'The Theory of the Firm,' *Working Paper*, Copenhagen Business School.
- Freeman, R. E. (1984), *Strategic Management: A Stakeholder Approach*, Boston, USA: Pitman.
- Gilson, R. J. and R. Kraakman (1994), 'Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate' in T. Baums, R. M. Buxbaum and K. J. Hopt (eds), *Institutional Investors and Corporate Governance*, New York, USA: Walter de Gruyter.
- Hadden, T. (1994), 'Corporate Governance by Institutional Investors? Some Problems from an International Perspective' in T. Baums, R. M.

- Buxbaum and K. J. Hopt (eds), *Institutional Investors and Corporate Governance*, New York, USA: Walter de Gruyter.
- Hart, Oliver (2001), 'Norms and the Theory of the Firm,' National Bureau of Economic Research, *Working Paper* 8286, <http://www.nber.org/papers/w8286>
- Iqbal, Zamir and Abbas Mirakhor (2001), 'Role of Stakeholders in Corporate Governance of Islamic Financial Institutions', *Conference Proceedings on Governance, Transparency and Risk Management of Islamic Financial Institutions*, Lebanon, Beirut, March, 2001.
- Islahi, Abdul Azim (1988), *Economic Concepts of Ibn Taimiyah*, Leicester, UK: The Islamic Foundation.
- Islam, Muhammad W. (1999), 'Al-Māl: The Concept of Property in Islamic Legal Thought', *Arab Law Quarterly*, 361-368.
- Jensen, M. C. and W. H. Meckling (1976), 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure', *Journal of Financial Economics* (October), 305-360.
- Jones, T. M. (1995), 'Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics', *Academy of Management Review*, **20**, 404-37.
- Kasey, K., S. Thompson, and M. Wright (1997), *Corporate Governance: Economic and Financial Issues*, Oxford, UK: Oxford University Press.
- Mehmet, Ozay (1997), 'Al-Ghazzali on Social Justice', *International Journal of Social Economics*, **24** (11), 1203-18.
- Milgrom, Paul R. and John Roberts (1992), *Economics, Organization and Management*, Englewood Cliffs, NJ, USA: Prentice-Hall Inc.
- Mirakhor, Abbas (1989), 'General Characteristics of An Islamic Economic System,' in Baqir Al-Hasani and Abbas Mirakhor, (eds.) *Essays on*

- Iqtisād: The Islamic Approach to Economic Problems*, MD, USA: Nur Corp.
- Mirakhor, Abbas (1995), 'Outline of an Islamic Economic System,' *Zahid Husain Memorial Lecture Series No. 11*, Islamabad: State Bank of Pakistan.
- Nabhani al-, Taqiuddin (2000), *The Economic System in Islam*, Lahore, Pakistan: Al-Khalifah Publications.
- Sen, Amartya (1993), 'Money and Value: On the Ethics and Economics of Finance', *Economics and Philosophy*, **9**, 203-227.
- Shleifer, A. and Robert W. Vishny (1997), 'A Survey of Corporate Governance', *Journal of Finance*, **LII** (2), 737-83.
- Tam, On Kit (1999), *The Development of Corporate Governance in China*, Cheltenham, UK: Edward Elgar.
- Tirole, J. (1999), *Corporate Governance*, Discussion Paper No. 2086, London, UK: Centre for Economic Policy Research.
- Turnbull, S. (1997) 'Stakeholder Cooperation', *Journal of Co-operative Studies*, **29**.
- Williamson, O. (1979), 'Transaction-Cost Economics: The Governance of Contractual Relations', *Journal of Law Economics*, **22**, 3-61.
- Williamson, O. (1985), *The Economic Institutions of Capitalism*, New York, USA: Free Press.
- Zingales, L. (1997), *Corporate Governance*, Working Paper No. 6309, Cambridge, MA, USA: National Bureau of Economic Research (NBER).

COMMENTS BY
Muhammad Umer Chapra

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

While the paper’s overall conclusion in favour of the stakeholders’ model and the scholarly manner in which it is arrived at are highly commendable, the paper stops far short of reaching the desired end. What is crucial is not just the defence of stakeholders’ rights, because the Franco-German model does the same⁵⁵ and some Muslim scholars have also defended these rights,⁵⁶ but rather to show how to ensure that these rights are protected. Here the authors rightly emphasize the role of rules of behaviour or what are now referred to as institutions in ‘Institutional’ Economics. This leads the reader to the more complex question of how these rules can be enforced. Here the authors have taken an easy way out by assuming that ‘in an Islamic system, the observance of rules of behaviour guarantee internalization of stakeholder rights (including those of the society at large). No other institutional structure is needed’. This is where, I think, the principal weakness of the paper lies.

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

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

A number of factors have dented the operation of incentives and deterrents in modern times. The first of these is substantial erosion of the conscientious religious environment which prevailed during the Classical period. This has weakened self-enforcement of norms by individuals. Secondly, there prevailed in the Classical period what Ibn Khaldun calls '*asabiyyah*' (social solidarity). Anyone who tried to violate the society's norms became ostracized. This ensured honesty and fairness in mutual dealings and acted as an informal contract enforcement mechanism. Thirdly, the market system worked more effectively because the firms operating in the market were generally small, being individual proprietorships and partnerships. Separation of ownership and control did not, therefore, exist

and the principal/agent problem was not serious. Moreover, competition was tougher as a result of the small size of firms and their large number. Market discipline, therefore, played an important role in the effective enforcement of the rules of behaviour. Fourthly, what helped was the independence, honesty and promptness of the judicial system. Courts as well as *muh̄tasibs* (ombudsmen) ensured that property rights were honoured and contractual obligations were honestly fulfilled.⁵⁷ Lastly, honest, conscientious and legitimate governments ensured the observance of the society's rules of behaviour by all, irrespective of their position in the society or the power hierarchy. Therefore, it was not just the rules of behaviour given by Islam, but also the socio-economic and political environment which led to the enforcement of property rights and contractual obligations.

Such an environment does not exist any more. As a result of the socio-economic and political decline in the Muslim world, the family, the society, the courts and the government, which are crucial elements of a proper enabling environment, do not play their roles effectively in the enforcement of values. The effective operation of incentives and deterrents has, therefore, become weak. The rules are still there but they do not get enforced. Observance of these rules starts in the family with the proper upbringing of children. Unfortunately, a majority of parents, and in particular mothers, are not well educated in Islamic norms. Institutional arrangements needed for such education are also grossly inadequate. The stress in religious education also seems to be, unfortunately, more on appearances and trivialities than on the uplift of character. This has been one of the primary factors which have contributed to an increase in the violation of Islamic norms. Those who violate the norms do not only not get socially ostracized, but are rather able to get prestige. The persistence of these violations over a long period has led

to their being locked-in in Muslim societies through the operation of path dependence and self-reinforcing mechanisms. Courts have also become corrupt and governments are generally illegitimate and not accountable before the people. It is, therefore, crucially important to change the environment so that everyone is clear about what the norms are and those who violate them do not only feel the pinch materially but also get socially ostracized. This would reduce the principal/agent conflict of interest by inducing individuals to do what is right and to abstain from doing what is wrong. Without a change in environment and social, political and judicial support, moral as well as legal norms are not likely to be effective.

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

It is also necessary to have a proper legal framework for the protection of stakeholders and its effective enforcement.⁵⁸ Countries with properly regulated markets have higher growth and are also less prone to economic crises.⁵⁹ Consequently legal protection has become an important variable of policy in most countries during the 1990s.

Legal protection may, however, be ineffective unless reinforced by independent, honest and efficient courts to promptly redress the grievances of stakeholders. It is also necessary to have effective internal controls, proper accounting, independent audit, and adequate transparency, to reduce the opportunity for managers and directors to serve their vested interests. In

spite of all these measures protection of stakeholders' right would tend to be weak if they are themselves unable to have a say in corporate decisions. The authors have rightly recognized this point. There is, however, no discussion in the paper of how to make it possible for the diverse stakeholders to have a say in corporate decision making.

All this does not deny the importance of moral values or rules of behaviour on which the authors have rightly laid great emphasis. The existence of legal and institutional protection and stakeholder participation in decision making, though necessary, will not be sufficient. There are so many clandestine ways of depriving stakeholders of their rights that both market forces and legal protection may be ineffective unless there is an inner urge on the part of agents themselves to fulfil their commitments faithfully. In societies where there is no conflict between moral norms and social behaviour patterns, moral norms as well as laws get enforced because, as Cooter (1997) has rightly put it, 'officials lack the information and motivation to enforce the law effectively on their own'.⁶⁰ Legal protection tends to be ignored when the law is inconsistent with 'actually prevailing' moral and social behaviour pattern. Consistency between moral and social norms and actual behaviour is considered to be indispensable 'social capital'.

Such social capital does not seem to be adequate in Muslim countries.⁶¹ Therefore, new laws will not by themselves be able to provide the necessary protection to stakeholders. Hence, while streamlining legal protection for stakeholders, we should bear in mind the stark reality that, in the last analysis, it may not be possible to ensure the honest and fair fulfilment of property rights and contracts without the help of moral values and their

implementation through an enabling socioeconomic environment and impartial judiciary.

Within the framework of Ibn Khaldun's analysis of the rise and fall of civilizations, moral norms, which emanate in his analysis from the *Shari'ah* in a Muslim society, may not get reflected in laws, and the laws may not get implemented effectively if the political authority does not attend to this task.⁶² It is the responsibility of the political authority to check all morally objectionable behaviour – dishonesty, fraud and unfairness – that is harmful for socio-economic development. It must also ensure the fulfilment of contracts and respect of property rights, and inculcate in the people qualities that are necessary for safeguarding the interests of all stakeholders.⁶³ The governments generally fail to perform these tasks if they are not accountable before the people, do not apply the law equally and equitably on all the different strata of the population, and do not employ staff on the basis of character and competence.⁶⁴

References

- Chapra, M. Umer, and Habib Ahmed (2002), *Corporate Governance in Islamic Financial Institutions* (Occasional Paper No. 6), Jeddah: Islamic Research and Training Institute/Islamic Development Bank.
- Chapra, M. Umer, and Tariquillah Khan (2000), *Regulation and Supervision of Islamic Banks* (Occasional Paper No. 3), Jeddah: Islamic Research and Training Institute/Islamic Development Bank.
- Cooter, Robert D. (1997), *Annual World Bank Conference on Development Economics, 1996*, New York: World Bank.
- Dasgupta, Partha and Ismail Serageldin (eds) (1999), *Social Capital: A Multifaceted Perspective*, Washington DC: World Bank.

- Dyck, Alexander (April 2000), 'Ownership Structure, Legal Protections and Corporate Governance', adyck@hbs.edu
- Ibn Khaldun, Abd al-Rahman (1968), *Muqaddimah*, Beirut: Maktabah Lebanon.
- La-Porta, R., F. Lopez-de-Salinas, A. Schleifer, and R. W. Vishny (1999), 'Investor Protection: Origins, Consequences, Reform', Harvard University, *Manuscript*, cited by Dyck, 2000.
- Macey, Jonathan R., and Maureen O'hara, 'The Corporate Governance of Banks', irm29@cornell.edu. And mo19@cornell.edu
- North, Douglas C. (1981), *Structure and Change in Economic History*; New York: Norton.
- Williamson, John (1993), *The Political Economy of Policy Reform*, Washington DC: Institute for Institutional Economics.

COMMENTS BY
Mohammed Obaidullah

The paper examines the relevance of stakeholder model of corporate governance in an Islamic economic system, which is an active area of research. The paper essentially asserts that a stakeholder oriented theory of corporate governance finds strong roots in the Islamic economic system. In what follows, I elaborate on some ideas contained in the paper and seek to some of them that appear to hold great potential for further research and analysis.

A somewhat narrow and early model of corporate governance called the ‘shareholder model’ of corporate governance focuses on the owner/investor/shareholder-manager relationship. It stresses that the objective of the firm is maximization of shareholders’ wealth. Managers as agents of shareholders have a fiduciary duty to engage in actions that help achieve this objective. A vast literature is devoted to identifying appropriate contractual mechanisms in order to resolve or mitigate the problems associated with the principal-agent relationship, commonly referred to as agency problems. It may be mentioned here that a fairly large number of studies have recently appeared that examine this issue in the context of Islamic financial contracts in general and participatory contracts in particular.

As pointed out by the authors, ‘business ethicists have generally considered this result to be ethically unacceptable because it unjustifiably neglects the rights of non-shareholder groups.’ Does this imply that we may find an appropriate model of corporate governance in the domain of Islamic ethics in contrast to the Islamic law of contracts? For example, employees

and consumers are important stakeholders in the firm. Islamic commercial law is quite explicit about the rights and obligations of parties in contractual mechanisms governing the employer-employee and seller-buyer relationships. Provisions seeking to protect the (informationally) weaker party are quite commonplace in the Islamic law of contracting (for example, *khiyār-al-ʿayb* or option against defects that seeks to protect the interest of the buyers). However, law perhaps does not take into account all the externalities imposed by shareholder wealth maximization choices on non-shareholder stakeholders. To cite an example, a *mudārabah* contract may be terminated with the consent of *mudārib* (manager) and *rabb al-māl* (finance providers) after a finite period resulting in closure of business. However, this may result in local communities suffering heavily from the closure of this business. Even while law would permit the owner of business to seek closure, ethical concerns may demand its continuation. Similarly, employees are understood to invest considerable human capital in the firm. While as per the explicit *ijārah* contract, an owner may terminate the employment after the contractual period is over, ethical concerns may demand his continuation for a time period long enough for him to find an alternative employment. With respect to consumer – another important stakeholder, law would permit the seller to price a product at a level deemed unduly high by consumers while ethics would demand setting prices at a ‘reasonable’ level that is not detrimental to consumer interests. It needs to be understood that Islamic law essentially defines the minimum level of ethics below which an act becomes impermissible. However, within the permissible domain, one may seek optimal governance structures that are ethical and that take care of interests of non-shareholder stakeholders. If we focus entirely on the ‘floor’ level of ethics defined by Islamic law of contracts, we may lose sight of the

exciting possibilities that Islamic ethics offers in terms of governance structures.

An interesting distinction is often made in the evolving literature dealing with stakeholders between explicit contracts and implicit contracts. Contracts between firm and financiers (*mudārib* and *rabb al-māl*), wage (*ijārah* and *juʿālah*) contracts, product warranties (*khiyār al ʿayb*) are all examples of explicit contracts. Many such contracts discussed in stakeholder theory literature are rooted firmly in Islamic law. Implicit contracts or ‘unwritten codes of conduct’ are relatively vague and informal. Examples of implicit contracts discussed in the literature are a firm’s commitment to neighbouring community, fair prices and continuing services for customers, job security to employees. Needless to say, as highlighted above, such contracts are rooted in Islamic ethics.

An alternative to the shareholder view is the neo-institutional view that argues that the firm’s claimants go beyond shareholders and bondholders and include others with whom the firm has any explicit and implicit contractual relationship. In this nexus-of-contracts view all stakeholders are regarded as contractors with the firm, with their rights determined through bargaining. As the authors state, there is nothing unique to corporate governance in this model, which simply becomes a more complex version of standard contractual governance. A model of governance based on Islamic contractual law would be similar to this model. Of course, this would be ethically more demanding. Under Islamic law, mutual consent that may be an outcome of bargaining is not enough for a contractual mechanism to be acceptable. Bargaining for example, may result in unacceptable contracts if either of the parties is informationally or otherwise disadvantaged.

In considering an Islamic view of the role of stakeholders, the authors note that ‘a firm in Islamic economic system can be viewed as ‘nexus-of-contracts’ whose objective is to minimize transaction cost to maximize profits and returns to investors subject to constraints that these objectives do not violate property rights of any party whether it interacts with the firm directly or indirectly.’ In pursuit of these goals, firm honours its obligations to explicit and implicit contracts without impinging on the social order. The authors, it appears, base their model on the Islamic principle of ‘freedom from *darar* or detriment’ This refers to the possibility of a third party being adversely affected by a contract between two parties. If a contract between two parties executed with their mutual consent is detrimental to the interests of a third party, then it may enjoy certain rights and options. (A case in point is the pre-emptive right or *shuffah* of a partner in joint ownership.) As they note, ‘in Islam, a stakeholder is the one whose property rights are *at stake* or at risk due to voluntary or involuntary actions of the firm.

A major part of discussion in the paper focuses on property rights in Islam. As the authors rightly point out, the notion of ownership in Islam is two-tiered. The former is real and absolute and belongs to Allah SWT only. The latter is delegated to man and restricted through time-bound possession. Further, this delegated right of possession is collective and individuals can only earn a priority in use of these resources. The authors use this line of reasoning to make a general case for stakeholder theory of firm. The case is well made. One wishes however, that the authors move beyond a general recognition of supremacy of collective and societal interests over individual interests. A formal presentation of stakeholder theory of firm requires a clear delineation of rights and obligations of various stakeholders in a firm, in addition to the society or Islamic state.

More importantly, the authors appear to leave the task of designing of a corporate governance system to the Islamic state. As they assert, ‘it would be the Islamic government that specifies the appropriate corporate governance structure, incorporating all stakeholders’ rights into fiduciary duties of managers of the firm on behalf of non-investors or stakeholders. So no other institutional arrangement that would allow individual non-investor stakeholders to negotiate directly with the firm is necessary. Incorporating all stakeholders’ rights into fiduciary duties of managers would be counter-productive and would lead to sub-optimal results.’ This is certainly debatable. Stakeholder theory is not about legislation. While we may agree to leave the task of legislation and regulation relating to corporate governance to an Islamic state, the basic issue is hardly addressed. The issue before researchers and scholars is to come up with alternative models of corporate governance and suggest an optimal one so that managers, directors, strategists, and management scientists can benefit from this theory. The authors seem to present this as a challenge for future researchers.

¹ Views expressed are of the authors and do not represent views of the World Bank Group or International Monetary Fund (IMF). Authors are thankful to the discussants for their comments. Authors would like to remind the readers that the objective of the paper is to highlight the sound foundation and relevance of stakeholders theory in Islamic economic system and the paper is not intended to make any suggestions on the larger design of governance system in Islamic economic system. Authors hope that this paper will serve the starting point for much needed research in this area.

² Kasey, Thompson and Wright (1997).

³ For a detailed discussion see, Balling, Hennessy and O'Brien (1998) and Bloomstein (1998).

⁴ Tam (1999).

⁵ Cornell and Shapiro (1987).

⁶ See Blair (1995), Turnbull (1997) and Tirole (1999) for a discussion of a society centered around protecting interests of all stakeholders.

⁷ Sen (1993) points out that it is precisely the denial of distinction between shareholders and others involved in the firm and the adoption of a more integrated view of the enterprise as ‘a large family,’ that has been a major force in the cooperative efficiency that Japanese industry has tended to achieve.

⁸ Baums, Buxbaum and Hopt (1994). The neo-institutionalists, rely on agency theory to define the firm as a ‘nexus of contracts’ and consider agents and transactions institutionally, societally, legally, culturally as contingent (incomplete) constructs.

⁹ Boatright (2002).

¹⁰ Zingales (1997).

¹¹ Donaldson and Preston (1995), Freeman (1984), Boatright (2002).

¹² Donaldson and Preston (1995).

¹³ Boatright (2002).

¹⁴ Jones (1995). Contract between a firm and its bondholders, wage contracts, or product warranties are examples of explicit or formal contractual claims that firms issue to non-investor stakeholders. Concept of implicit contracts is more delicate and refined. Implicit contracts between the firm and stakeholders are relatively vague and informal, and no documents exist to describe these contracts.

¹⁵ Examples of implicit contracts include a firm's commitment to neighbouring community, the promise of continuing service to customers, and job security to employees. Another example of implicit contracts is between a bank and its major customers that ensure provision of credit. Japanese and Korean (as well as other economies) top industrial firms were shown to have binding implicit contracts with the banks.

¹⁶ Foss, Lando and Thomsen (1998).

¹⁷ Donaldson and Preston (1995).

¹⁸ *Shari'ah* scholars consider that the human self or soul (*nafs*) has ‘rights’ as well as many duties and responsibilities. The basis of this is the fact that when a person violates these rights he is said to have ‘wronged’ (*zulm*) his/her soul (see for example verses 2:231 or 37:113).

¹⁹ Imam Zayn al-Abidin's treatise on the rights, *Risālat Al-ḥuqūq* covers a full spectrum of rights in Islam. For example, the right of one's property (*al-māl*) is that one takes it only from what is lawful and spends it only on what is proper. The right of the associate is that one neither misleads him, nor acts dishonestly toward him, nor deceives him. The right of the adversary (one who has a claim against someone) is that, if his claim is valid, one gives witness to it against oneself [ali ibn al-Husayn (1990)].

²⁰ Ali Ibn al-Husayn (1990).

²¹ Islam (1999) The term *māl* or its derivatives have been mentioned in the Qur'ān in more than 90 verses and in numerous sayings of the Prophet (pbuh).

²² See Mirakhor (1989) and Ahmad (1995).

²³ Allah (S.W.T) explicitly states that '*Believe in Allah and His messenger, and spend of that whereof He made you trustee.*' Qur'ān (57:7). By implication, the ownership of property (*al-māl*) is understood to be a trust and is considered to be a test of faith. [Bashir (1999)].

²⁴ Mirakhor (1995) makes reference to a number of verses to support this axiom. For example:

هُوَ الَّذِي خَلَقَ لَكُمْ مِمَّا فِي الْأَرْضِ جَمِيعًا

'He it is who has created for **you all** that is on earth' Qur'ān (2:29).

Both *لَكُمْ* and *جَمِيعًا* refer to collectivity for whom the plurality of resources have been created by Allah (S.W.T). In another verse, Allah (S.W.T) says:

وَلَا تُؤْتُوا السُّفَهَاءَ أَمْوَالَكُمُ الَّتِي جَعَلَ اللَّهُ لَكُمْ قِيَدًا

'Do not give your **resources** that Allah has made you its preservers on to the foolish' Qur'ān (4:5).

Again, *أَمْوَالَكُمْ* and *جَعَلَ اللَّهُ لَكُمْ قِيَدًا* indicate the right of collectivity.

²⁵ Mirakhor (1989). Based on the principle of justice, and the recognition of man's natural tendencies, rights, and obligations, individuals are allowed to appropriate to themselves the products resulting from the combination of their labour and certain of these resources—without the collectivity losing its original rights either in the resources or the products

resulting from the individual's creative labour applied to these resources in accordance with the rules, specified by the *Shari'ah*.

²⁶ Ibn Taimiyah was one of the earliest scholars to recognize and to advocate the rights of the society and the state along with the private ownership. Islahi (1988) claims that this distinguishing characteristic of his economic views is not found in any of scholastic scholars.

²⁷ Mirakhor (1989).

²⁸ The Prophet (pbuh), during his last sermon at Arafat declared the inviolability of property to be at par with that of life and honour: 'Like this day of this month in this territory, sacred and inviolable, Allah (S.W.T) has made the life and property and honour of each of you onto the other until you meet your Lord.'

²⁹ Islam, Muhammad (1999).

³⁰ Islahi (1988).

³¹ Bashir (1999).

³² Behishti and Bahonar (1990).

³³ Nabhani al- (2000).

³⁴ These rules are supported by various verses in Qur'^{ān} as following:

'And do not eat up your property among yourselves for vanities, not use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people's property.' Qur'^{ān} (2:188).

'Those who when they spend are not extravagant and not niggardly, but hold a just (balance) between those (extremes).' Qur'^{ān} (25:67).

'Behold, the squanderers are, indeed, of the ilk of the satans....' Qur'^{ān} (17:27).

³⁵ The concept that man has an unrestricted handling authority over his wealth is unacceptable. Allah (S.W.T.) has condemned the people of Prophet *Shuayb* for adopting such an attitude. See Qur'^{ān} (11:87), Ahmad (1995)].

³⁶ Bashir (1999) argues that Islam attaches great importance on protecting people from harm caused by others. The Prophet is reported to have said *'to cause harm to others is not allowed in Islam.'*

³⁷ Some cultures and religions forbid property rights altogether. Among many of the native peoples of North America, the idea that someone could somehow 'own' the land was

unimaginable, while Hutterites practice Christian communism, living together in very successful farming communes in Manitoba, Saskatchewan, and North Dakota, where all material goods are held in common. Milgrom and Roberts (1992).

³⁸ Mehmet (1997) gives an overview of Ghazali's economic ideas, which are based on private property and ownership, but economic relations are subject to self-imposed (voluntary) rules of moderation, honesty, and integrity. However, this view makes Ghazali a non-Hellenic and non-rationalist in standard Western terms.

³⁹ Mirakhor (1989).

⁴⁰ Relationship between Allah (S.W.T) and human beings initiated as a contract. A covenant was made when Allah (S.W.T) asked, '*Am I not your Lord?*' to which human beings replied, '*Yes, we testify.*' Qur'^{ān} (7:172).

⁴¹ See for example Qur'^{ān} (30:6).

⁴² The Prophet is also reported as having said that '*a person without trustworthiness is a person without religion.*' Mirakhor (1989).

⁴³ Qur'^{ān} (5:1).

⁴⁴ Mirakhor (1989).

⁴⁵ Since, implicit claims are too nebulous and state contingent to reduce to writing at a reasonable cost and therefore they cannot be unbundled and traded independently from the goods and services the firm buys and sells. Typically, a firm can default on its implicit promises without going bankrupt or liquidation. Cornell and Shapiro (1987).

⁴⁶ The notion of accountability in the Hereafter is a major motive to comply with implicit contracts. Similarly, the notion of blessing in Hereafter provides a strong incentive to comply with implicit contracts.

⁴⁷ Classical definition of stakeholders is given by Freeman (1984) as any group or individual who may affect or be affected by the attainment of the firm's goals. Donaldson (1989) argues that this definition lacks any normative rationale or criteria for identifying who the stakeholders are or for allocating the rights corresponding to each one. Clarkson's (1995) offers a refined view of a stakeholder based on the stakeholder's exposure to the risk (a hazard, a danger, or the possibility of suffering harm or loss) as result of firm's activities.

⁴⁸ **Ṣaḥīḥ** Bukhari, Volume 1, Book 2, Number 10.

⁴⁹ Tirole (1999).

-
- ⁵⁰ Boatright (2002).
- ⁵¹ Mirakhor (1989).
- ⁵² Iqbal and Mirakhor (2001). It is assumed that the social, legal and political environment surrounding the economic system is also in compliance with the Islamic rules.
- ⁵³ Boatright (2002).
- ⁵⁴ Boatright (2002).
- ⁵⁵ Macey and O'hara (2001), pp. 1 and 5.
- ⁵⁶ Chapra and Ahmed (2002).
- ⁵⁷ For a more detailed discussion of these factors see, Chapra and Ahmed (2002), pp.2-7.
- ⁵⁸ See Chapra and Ahmed (2002); see also Chapra and Khan (2000).
- ⁵⁹ La Porta, et. Al (1999).
- ⁶⁰ Cooter (1997), p.191.
- ⁶¹ For a valuable discussion of social capital, see Dasgupta and Serageldin (1999).
- ⁶² Ibn Khaldun, *Muqaddimah*, pp.190-91.
- ⁶³ It is only recently that the political dimension of economic reform and development has started to receive analytical attention. Douglas North emphasized that the only way economies can develop optimally is to keep 'nasty' behaviour in check. Governments are capable of doing this. If they do not, individuals may behave in ways that could undermine the very foundation of the system and lead to social chaos and economic collapse (See the Chapter, 'Ideology and the Free Rider', in North, 1981). John Williamson has also focused on the political context of successful economic reform by analyzing 11 developed and developing countries [See Williamson (1993)].
- ⁶⁴ Ibn Khaldun has devoted to this question a whole chapter entitled 'Human Development Requires Political Leadership for its Proper Ordering' in addition to substantial discussion in several other chapters. See his *Muqaddimah*, pp.235-43.