1. Introduction

The Islamic economy is essentially a market economy, although the state has an important role to play as well. But, the role of the market in the Islamic economy differs markedly from that in secular systems. The distinction lies critically in the role of the individuals as producers, distributors and consumers in the Islamic versus secular paradigms. Injunctions from Qur'anic revelations and the Sunnah (the Traditions of the Holy Prophet) guide individuals on how they should conduct themselves and their affairs, and these include commercial transactions (mu'āmalāt).

Islamic jurisprudence (fiqh) contains clear demarcations between what is permissible and what is not permissible in Islam. Where there are ambiguities, the Muslims are urged to resort to reasoning by drawing parallels through Islamic examples (qiyās) and consensus (ijmā') and not to rely on their own opinions (ra'y). Generally Islam, as a way of life, calls for moderation and decries excessiveness.

*Mohamed Ariff is the Director General of the Malaysian Institute of Economic Research, Level 9, Block C, Bank Negara Malaysia, Kuala Lumpur, Malaysia.
Thus, the marketplace in an Islamic economy is tempered or restrained by Islamic morality and ethics. While these restrictions or restraints tend to limit the freedom of the market forces, they are not aimed at making the marketplace less efficient. On the contrary, these restrictions can help remove market imperfections so that the market can function more efficiently. For more often than not, the market tends to go to excesses when left on its own. On the other hand, a complete suppression of the market is also undesirable as it would lead to inefficient resource allocation and welfare loss. As a rule, Islam takes the middle path.

2. The Right to Choose

In Islam, men and women represent the finest of God's creations, endowed with the faculty to think and reflect, and appointed as the vicegerents of God on earth. Free will and accountability are the two most important components of this package deal, i.e., the covenant. Individual freedom is enshrined to such an extent that compulsion and coercion are disallowed even in the choice of religion. The humans thus have a right to choose and this freedom of choice is extended not only to religion but also to all other aspects of human existence, including day-to-day decisions in the marketplace.

Just as the economic freedom of the individual is upheld in Islam, no individual can impose his will or exert pressure on others. In Islam, the market constitutes a forum where individuals make decisions collectively by casting their votes through their commercial transactions. It is only in this narrow sense that Adam Smith’s “invisible hand” characterisation of anonymous market forces corresponds to the Islamic approach.

Economic freedom of individuals entitles them to private ownership of not only properties and wealth but also production facilities. According to fiqh, private enterprise is permissible in all
fields except those reserved for the state (e.g., mineral resources), not to mention the production and distribution of goods and services the consumption of which is prohibited (harām) in Islam (for example, liquor and gambling). Historical evidence also shows that entrepreneurs in Islamic states were free to manage their businesses without much state intervention, with the Islamic legal system protecting private investments and determining the legitimacy of commercial transactions. Private enterprises have thrived in Islamic communities during the classical days. The Holy Prophet (p.b.u.h) did encourage his followers to engage in a variety of economic activities, including trade, farming, horticulture and animal husbandry, all of which were in vogue then.

The market has played a pivotal role in the economy of Islamic polity right from the beginning. It is significant to note that the Holy Prophet (p.b.u.h) had refused to fix the prices of goods even when they rose very sharply in the wake of acute shortages, leaving them to be determined by market forces. Fair competition among sellers then constituted a sufficient safeguard against rising prices. It is now well understood that price controls by government authorities will impede supply responses and tend to worsen, and not redress the shortage problem that causes prices to soar in the first place.

3. Ethical Limits

To be sure, the right to choose which is enshrined in Islam is accompanied by accountability. Individuals can exercise their free will, but they will have to account for it on the Day of Judgement and pay a "price" for misusing or abusing this right during their sojourn in the present world. Islam has provided Heavenly guidance to the human race through Divine revelations on how people should conduct their affairs so that they can triumph both in this world and in the Hereafter (i.e., to achieve fulāh). All these have important economic implications in terms of consumer behaviour, production pattern,
business conduct, and wealth creation and redistribution.

Commercial transactions of *halāl* (permissible) goods and services in the marketplace are legally acceptable in Islam only if these take place to the full satisfaction of both the seller and the buyer. In other words, a legitimate exchange according to Islam is one that is mutually beneficial to both parties. It ought to be a positive-sum game so that one does not gain at the expense of the other. Islam disapproves of transactions that are fraudulent in nature and insists that every transaction be free from deceit and exploitation. Outbidding (*al-musawamah*), trickery (*al-najsh*), concealing defects in goods sold, cheating on weights and measures, and the like are strictly forbidden. What is more, Islam does not legitimise transactions that are shrouded in ambiguities (*gharar*), i.e., exchange involving unspecified price, quality, delivery, and etc.

While Islam allows market forces to determine the price in a competitive fashion, it rejects attempts by producers and traders to manipulate the price by withholding supplies and other means. It is pertinent to observe that the Holy Prophet (p.b.u.h) had disallowed traders to intercept farm producers on their way to the marketplace before the latter could monitor the market trends. Hoarding of goods with an intent to push up the prices is condemned. Blackmarketing, considered as a form of "forced trade," is disapproved in no uncertain terms. In the same vein, it is also unlawful in Islam for a merchant to underprice his product in such a way as to inflict losses on other merchants. And finally, as it is well known, interest (*ribā*) is prohibited.

4. **State Intervention**

The prowess of the private sector is duly recognised in Islam. Accordingly, the private sector is given considerable leeway, subject to the salutary checks of Islamic ethics. Islam permits acquisition of wealth through legitimate means, but private ownership is not absolute.
In a sense, the term "ownership" is a misnomer, since everything in the universe belongs to God Himself, and private ownership is seen as no more than "trusteeship." Man enjoys the right to acquire property, use it, pass it on to his heirs, or dispose it off as he pleases, but he has no right to destroy it, as he holds it only in trust. The logic is simple: man brings nothing with him when he is born and takes nothing with him when he dies. Everything he can "own" while he is alive is only on lease.

Thus, there are effective property rights in Islam, notwithstanding the special connotations attached to the concept of ownership. And, all this is consistent with the importance accorded to the role of the market for it cannot function in the absence of effective property rights.

The Islamic perception of the private sector differs sharply from that of Capitalism which glorifies it in a no-holds-barred fashion and of Communism or Socialism which throttles it. Islam drives a middle course by encouraging it, subject of course to the salutary checks referred to earlier. The notion that a perfect market can ensure efficiency in resource allocation is not inconsistent with Islamic percepts, but there is no place in Islam for laissez-faire, not only because Islam calls for ethical restraints but also because the market by itself cannot always ensure equity, especially if there are market imperfections. Accordingly, Islam permits state intervention if there are market failures. Much however, depends on the nature of intervention. The assumption here is that state intervention will lead to better results. If the danger of state failure is greater than that of market failure, one may object to state intervention as Islam clearly opts for the lesser of the two undesirable alternatives.

In this context, reference must be made to the Islamic institution of al-hisbah whose job it is to see that moral and ethical norms, and safety and healthy standards are observed in the marketplace and that fair play and sound macroeconomic environment prevail. Equally
interesting is the principle of al-himā which protects investors from unfair competition.³

There is provision for state intervention to enforce Islamic restrictions on certain economic activities. As mentioned earlier, consumption of certain goods, such as alcoholic beverages, and services, such as gambling, are prohibited. In addition, Islam also imposes a quantitative prohibition of extravagance in the consumption of permissible items, as Islam calls for moderation in consumption. Islamic restrictions on investment are only a few. Needless to say, what is prohibited in consumption are also prohibited in production. Investment involving ribā is disallowed. Islam calls for a fair distribution of risks between investors and entrepreneurs through such means as equity participation (mushārakah) and profit-sharing (mudārah).

5. Market and Economic Analysis

What does all this mean in terms of economic analysis in general and the Theory of the Firm in particular?

Economic theorising cannot divorce itself from the ways in which actors in the market behave. Conventional economic analysis is based on the notion of “Economic Man,” a self-centred individual, who counts every cost and every reward no matter what, and one who is incapable of taking into account the impact of his behaviour on others. Whether this representation of human behaviour is a fair description for any community or not is a moot question. In any case, this does not conform to the Islamic concept of Man as the vicegerent of God.

Such Islamic virtues as diligence, thrift, moderation, balance between this world and the Hereafter and care for the immediate kith and kin and society at large have important implications for economic analysis. Thus, for example, moderation in consumption tends to curb
price increases and reduce negative externalities associated with excessive consumption. In the same vein, the utility function of consumers will reflect not only personal preferences but also the concern for others, as one is enjoined to wish for others what one wishes for oneself. Besides, the "Islamic Man" would attempt to maximise his utility not just in his present existence but also in the Hereafter through good deeds. Such considerations warrant new approaches in economic theorising.

In a market economy, it is the consumer who calls the shots by casting his "vote" through his expenditures, while producers respond to consumer signals. This is more so in an Islamic economy than in a secular one. Such textbook questions as "what to produce" and "for whom," are determined essentially by the demand side of the equation, while the supply side is concerned basically with the "how" question, as this would determine the profitability and hence the return to investment. This does not mean that the firms will not come up with new products, as competition among firms will lead to innovations and inventions through R & D (research and development) activities in their endeavours to reduce production cost and improve product quality. However, the ability of the firms to manipulate demand through persuasive means that would fuel human temptations is rather limited in the Islamic order, since the function of advertisements is to merely keep the consumers well informed of the range of options available to them so that they can make a rational choice. In such a system, the market is cleansed of impurities that often encourage market excesses in Capitalist societies.

Profits play a central role in all market economies. Private sector initiatives are motivated and driven largely by profit considerations. Profits are the rewards for entrepreneurs who organize production and undertake risks in the face of uncertainties. Islam legitimises profit but not profiteering, a distinction often blurred in the rugged Capitalist markets where such ethical boundaries do not
exist.

While profits are legitimate in Islam and have an important role to play in an Islamic economy, they are by no means the be-all and end-all of entrepreneurial activities. It is only in this limited sense that the concept of profit maximisation is alien to Islam. However, it is pertinent to point out that the profit maximisation hypothesis does conform to the Islamic concept of profit making in the case of "perfect" competition where profits are just "normal." Even where competition is imperfect, the long-run equilibrium of normal profits in a capitalist order is not incompatible with the Islamic notion of profit making. It is only when "abnormal" or "super-normal" profits are made, that the profit maximisation hypothesis would run apparently counter to the Islamic stance.

Be all that as it may, the concept of profit maximisation, as an analytical implement, makes considerable sense even in an Islamic economy to the extent that it can help allocate resources efficiently. This is because profit-maximising behaviour will ensure that factor proportions, output and price are all just right. It is imperative in Islam that God-given resources be used most efficiently. If this can be ensured by simply equating marginal revenue with marginal cost, there can be no Islamic objections, provided that profits so maximised are also just normal.

However, one must not lose sight of the fact that short-run abnormal profits are only temporary, given that there is free entry to the market. The Islamic objections to abnormal profits are particularly strong where these result from collusion among firms, as in the case of oligopoly and duopoly or from monopolistic maneuvers in the name of profit maximisation.

Where profits tend to be abnormal, an Islamic solution would be to push production beyond the point at which marginal cost is equated with marginal revenue to a level where average cost equals average revenue. This will yield increased output a lower price. This
would amount to passing on the "excess" profits to the consumers.

It is not so much profit maximisation per se, but how profits are maximised, that poses an ethical dilemma. The question of equating marginal cost with marginal revenue represents only a small technical detail and as such does not represent the real issue. The real issue is what goes into the cost and revenue schedules. For instance, misleading advertisements can shift the revenue curves up, while externalisation of pollution costs can push the cost curves down so as to raise profits. Neither of these is acceptable in Islam.

In other words, profit maximisation in an Islamic framework can yield results that are significantly different from that in a Capitalist framework. To take the preceding example, internalisation of pollution costs by all firms in an industry will shift the supply curve to the left so that less will be produced and consumed at prices that truly reflect the social costs, whereas externalisation of such costs would lead to under-pricing, overproduction and excessive consumption with the environment taking a heavy toll.

One may surmise from all this that the principle of profit maximisation in itself is not antithetical to the Islamic paradigm. Maximisation of profits, subject to the rules of the game laid down by the Qur'ān and the Sunnah, is quite consistent with the Islamic emphasis on economic efficiency and social justice.

6. Conclusion

Islam may appear to be akin to Socialism to some observers because it has definite socio-economic objectives and clear guidelines. The truth, however, is that collectivism and regimentation cannot jive with the basic Islamic axiom which stresses the fundamental rights of individuals including the freedom of choice. Centralised planning and state organisation of production and distribution of goods run counter to the Islamic philosophy. In Islam, every individual is free to
produce, sell, buy and acquire as he or she pleases according to one’s ability or capacity, although there are clear injunctions relating to all economic activities. The only real catch is that each and everyone is accountable for his or her own deeds on the Day of Judgement. Seen in this light, the market is an integral part of the Islamic economic system as it symbolises the economic freedom of individuals.

However, economic freedom of mankind is by no means absolute. Accordingly, the freedom of market forces in an Islamic society is constrained only by ethical norms. It is in this sense that the role of the market in Islam differs from that in secular systems. It may be mentioned in passing that even in Capitalist societies, markets are regulated. The fundamental difference is that regulations in secular markets are manmade, whereas in Islam these are based on Divine guidance. The difference between these two approaches stems primarily from the unique Islamic perception of the nature and purpose of human existence and endeavour.

It can be gleaned from all this that the market performs in a more responsible fashion in an Islamic system, thanks to the ethical values regulating or moderating the market forces. Islamic values only tame, not cripple, the wild market forces so that it can function in an orderly manner. State intervention is permissible if the market fails to deliver. It is important to add that, in essence, state intervention is seen not as a substitute for, but as a supplement to, market mechanism. The main objective of such intervention is to help the market function better by removing impediments, such as insecure tenure, negative externalities, unpriced resources and monopolistic elements and malpractices, all of which cause market failures.

Endnotes

1. This refers to the practice of outbidding after a contract has been agreed between two parties. Islamic injunction against outbidding holds even
though the offer of a person already accepted by the vendor may not yet be irrevocable.

2. This refers to a practice where one offers a high price for a good with no real intention of buying it but just to mislead another person who really wants it.

3. This term literally means protection. This principle was applied to forbid the digging of wells within a certain radius of an existing well so as to protect its sources of water. The purpose is to protect the investment that has gone into the digging of the existing well. This principle can be invoked to protect investments in agriculture, industry and trade from unfair competition.

Selected References


