

ECONOMIC PRINCIPLES IN ISLAM: SOME METHODOLOGICAL ISSUES

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Abstract

This paper examines the nature of economic principles in Islam. Two types of economic principles are identified. The first type refers to the economic laws derived from revelation-based sources namely the Quran, Sunnah, Ijtihad and Ijma. The second type refers to economic laws derived from reasoning and experience. The former is the economic system and the latter is economic theory. Both forms of economic laws are in harmony and have no basis for compartmentalization as there is no conflict between revelation and science in Islam. In theory building, it is shown that Quranic based assumptions act as the linking mechanism in harmonizing revelation and science. As revelation is superior to reason and experience, modification of economic models for empirical verification must not involve changes in Quranic based assumptions. Only the observed or tabi' based assumptions are subject to modifications.

1. Introduction

Economics is a study of human behaviour with respect to the allocation of scarce resources among competing ends. How man overcomes the problem of resource allocation heavily depends on the value system governing his behaviour. Values define what is right and wrong, good or bad. But the basis on which value judgement is made to define humanly conducts varies

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between individuals and societies. Similarly, deriving economics principles to solve basic economic problems depends on one's belief and ideology. Sources of truth from which economic principles are derived may come from sense experience, natural laws and revelation. The purpose of this paper is to highlight the sources of economic principles in Islam. The primary source of economic principles in Islam is Revelation (*wahy*). However, the nature of the secondary source of economic principles in Islam, i.e., economic theory, has received less attention in Islamic economic literatures. This article seeks to show that legal, ethical and scientific teachings of the Quran form an integral part in economic model building thus making Islamic economic theory shariah-oriented. Even though logical empiricism remains dominant in model construction, no inherent conflict is expected from Quranic and scientific values in modeling. By scientific values we mean values derived from reasoning and empirical experience alone. As Islam enjoins scientific inquiries, we will show that in Islamic theory building, no dualistic approach is used to compartmentalise these scientific values¹ from the legal and ethical teachings of the Quran.

2. Review of Literature

Dissecting scientific values from Quranic values would then imply failing to distinguish between what the Quran says about human behaviour and natural law. For example, it is misleading when output in a production function is defined in terms of *halal* and *haram* goods as the basket of goods in the Islamic economic system is readily defined by the Shari'ah. In other words, the production function does not need any redefinition of output and input along Islamic lines to make it an Islamic one. The very nature of the production function itself is Islamic as it is a manifestation of natural law. What needs to be investigated are the underlying assumptions of the production theory while leaving the objective function intact.

Attempts to compartmentalise scientific values from Quranic values in theory building are not new among Muslim writers. For example, the objective of household spending in Islam according to Fahim Khan is to fulfill the worldly needs and the Hereafter. There are two components in the expenditure constraint. First, to purchase essential goods to fulfill his private and family needs. Secondly, he spends to satisfy the needs of others with the expectation of rewards in the Hereafter². The former means worldly expenditure and the latter as expenditure in the cause of Allah. Elsewhere, Metawally's utility function of a Muslim entrepreneur is said to depend on

problem, i.e. the data base, required investigation⁸. This is what Moten and Bajulaiye-Shasi called low-level assumptions that are testable under the twin criteria of reason and empirical evidence⁹. On the contrary, high-level assumptions derived from Quranic values are not testable as the Quran is the source of truth in Islam. Although both approaches gave a general guidelines how one should proceed in Islamic economic modeling, the definitions of low-level and high level-assumptions and how empirical contents are related to the above were not well spelt out.

3. The Shari'ah¹⁰ and Economic Principles in Islam

The interaction of Quranic and scientific values in economic modeling requires closer look into the nature of values in the Quran and science. Values are judgements about human character or conduct. These are knowledge about the right and the wrong for which the source is revelation. On the other hand, science says that the source of truth is sense experience alone but this does not imply that scientific values are alien to Quranic values. In fact, the Quran appeals to science so that man is aware of God's creation and therefore submit to His Will. Since economics is a study of human behaviour, it is more convenient to relate the Quran and man in the lights of ethico-legal values instead of adopting a wholesome approach of values in the Quran that also include nonhuman. To that effect, the term Shari'ah law or *hukm shari'ah*¹¹ (plural *Ahkam shari'ah*) will be used to designate ethico-legal dimension of the Quranic values in which the main subject is man.

Principles are fundamental rules and code of conduct governing society without which life will be plagued with lawlessness and destruction. In this sense, *shari'ah law* represents the source from which principles are formulated to guide human behaviour. In the same vogue, economic principles are rules and regulation derived from *shari'ah law* to guide economic decision making towards solving basic economic problems. For example, in Islam, the problem of relative scarcity demands economic agents to make choices such that the problems of resource allocation, distribution, stability and growth can be overcome. It is here that the making of economic decision is buttressed upon general economic principles derived from the *shari'ah law*.

In Islam, the source of economic principles is the Shari'ah. They are revealed principles¹² and thus make the notion of economic principles in

the Islam unique and different from conventional norms. As an example in conventional economics, principles about consumer behaviour can be obtained through the process of deduction and induction. Therefore, the principle or theory of demand states that price and demand for a particular commodity is inversely related. This rule is also called economic theory. It is factual as no relation with Holy Scriptures is made, even though the assumptions underlying the theory may contain some value oriented ingredients. However, in Islam, certain rules and guidelines about how economic life is governed are given in the Quran. It is on these rules that an Islamic economic theory is based which apparently makes the "Islamic" economic theory loaded with revealed values.

In this sense, economic principles in Islam can be divided into two, namely, the **revealed principles** and **observed principles**. The former refers to the economic principles derived from Quranic values or *ahkam al-Quran* and takes into operational mode as *shari'ah law*. This is where the economic system comes in place. Observed principles however, refer to the economic principle buttressed on reasoning and experience that is commonly known as economic theory. Since reasoning and experience are two universal sources of knowledge and therefore Quranic-based (7:179; 67:3-4; 31:20), they are bound under the term *hukm tabi'* or natural law.

4. Quranic values and Shari'ah Law

The Quran contains principles about human behaviour. These principles are given in the teachings about faith (*aqidah*), ethics and morality (*akhlak*), rituals, rewards and punishment. Others include laws and rules about the relationship of God, man and society and finally, stories about past civilizations. *Shari'ah law* is based on these Quranic principles or values (*ahkam al-Quran*). Although in juristic literatures, *shari'ah law* is applied exclusively to the legal problems, the author assumes that the legal content of the *shari'ah* is embodied with Quranic ethical teachings. However, this may not be the case in Islamic history¹³. Therefore, to avoid the treatment of ethics and legal character of the Quran into two dual entities which Islamic economics also wants to avoid, the term *shari'ah law* and *ahkam al-Quran* are assumed synonymously. However, one must note the difference between *shari'ah law* and *hukm al-Quran*. The former is exclusively revealed to guide human behaviour while the latter includes other creations of God such as the animals and plants. As economics is a study of human behaviour, the term *shariah law* or *hukm shari'ah* is

preferably a better choice¹⁴.

According to Islamic jurist, *hukm shari'ah* is God's commandment related to the actions of all responsible Muslims (*mukallaf*), as obligatory (*wajib*), forbidden (*haram*), recommendable (*sunnat*), disliked (*makruh*) or permissible (*mubah*). According to Iman Shatibi, the objective of the *shari'ah law* (*maqasid shari'ah*) is to protect the general welfare of the people (*maslahah al-ammah*) which clearly implies that the *shari'ah law* is designed by God for man alone¹⁵. This protection entails the protection of religion (*deen*), life (*nafs*), intellect (*aqal*), family (*nasab*), wealth (*mal*). For example, the prohibition of Riba in the Quran serves to protect the wealth of the ummah from accumulating among the few. This is because Riba is a form of unfair business practice of which the profits obtained is illegal. However, the prohibition of Riba in the Quran is a legal sanction but the moral teaching behind the prohibition is justice or 'adl. Again one can see that the term *shari'ah law* used in this article would imply both the ethical and legal rules. These ethical and legal content of the Quran will be discussed under three broad categories of *hukm shari'ah* namely, *Hukm 'Iqtisadiyah*, *Hukm Akhlak*, *Hukm Amaliah*¹⁶.

1) *Hukm 'Iqtisadiyah* is about faith or *Aqidah* according to which a Muslim believes in Allah S.W.T., the Prophets, the Angels, the Holy Books, the Hereafter and predestination. These laws named the pillar of *Iman*, are absolute and permanent without life is sterile and meaningless.

2) *Hukm akhlak* refers to the ethical teaching of Islam in which the central core is the concept of *taqwa*. By *taqwa* we mean God consciousness or keen sense of responsibility. It is *taqwa* that makes acts of high ethical and moral standard a reality without the enforcement of sanctions. The role of *hukm akhlak* thus is to guide, refine and enrich man's behaviour by making God's commandments as obligations with or without legal injunction. For example, paying zakat on wealth is a legal obligation of every Muslim. However, manipulating zakatable wealth with an intention to avoid zakat is legal but may be unethical¹⁷. Therefore, *hukm akhlak* or ethical teachings in the Quran such as *taqwa*, 'adl, *imaan*, *sidiq*, *zuhd*, *amanah*, *sabr*, *shukr*, etc. are intended to lubricate the gearing wheels of legal injunctions in Islam such that the essence of justice which, for example Zakat is supposed to manifest, is realized.

3) *Hukm amaliah* can be categorised into two, namely *hukm 'ibadat* and *hukm muamalat*. *Hukm 'ibadat* refers to the law of rituals in Islam such as prayer, zakat, fasting and hajj. These laws are absolute and clearly explained in the Quran and Sunnah. On the other hand, *hukm muamalat* deals with rules and regulation governing society. It can be divided into seven parts, namely procedural law (*ahkam-ul-murafa'at*), laws about legislation (*ahkam-ul-dusturiah*), laws about the household that include marriage, divorce, kinship and inheritance (*ahwalus syakhsyiyah*), laws of contracts and business transaction, leasing, employment (*ahkam-ul-madaniyah*), laws about criminal actions like qisas and hudud (*ahkam-ul-jinaiyah*), laws about sources of public finance, rights of the poor, monetary relations between state and the masses (*ahkam-ul-Iqtishadiyah-maliyah*) and laws about international relations (*ahkam-ul-da'uliah*). These are the legal content of the Quran embodied by Muslim jurists into legal enactments subject to change according to the rule of need and necessity. For example, in polygamy, some countries like Egypt, Tunisia and Malaysia require the husband to seek permission of the first wife if he plans to do polygamy. This is done to uphold justice in case the former abuses his right to polygamy such as giving unfair treatment to the first wife. Likewise in *hukm jenayat*, the hudud system gave special exception to theft punishment during period of famines.

As mentioned earlier, the objective of *shari'ah law* is to protect the welfare of the ummah in which relationship of man with God (*hablumminallah*) as well as relationship between man and man (*hablumminannas*) are defined. These regulations and rules (*hukm shari'ah*) which are explained below are classified into two, namely, *hukm taklifi* and *hukm wadh'i*. *Hukm taklifi* define the values or *ahkam* of conduct in legal terms such as *wajib*, *sunnat*, *mubah*, *makruh* and *haram* which play an important role in economic modeling. *Hukm wadh'i* explains the reasons behind each legal rule. For example, the Quran says, *thieves man and women, cut off both hands 5:38*). The *taklifi* component refers to the cutting of hands which is *wajib* while the *wadh'i* component indicates stealing as the cause for the amputations. Therefore, one can observe that the *shari'ah law* defines not only the value or knowledge about right and wrong of actions but explains the reasons behind these rulings.

5. Sources of Shari'ah Law

The Quran is the main source of law in Islam. According to Ahmad Hasan, the term law above "includes both the moral laws and the legal enactments." In the Quran, legal rules may be divided into two broad categories, namely permissible (*halal*) and prohibition (*haram*). However, the development of fiqh in Islamic history has broaden these categories into five fixed legal values (*al-ahkam al-khamsah*) namely *wajib*, *mubah*, *makruh* and *haram*. Apart from the Quran, these categories are based on three other foundations (*usul*), namely the *Sunnah*, *Ijma'* and *Ijtihad* or *Qiyas*. The *Sunnah* refers to the model behaviour of the Prophet. It gives the concrete shape to the Quranic teaching through the Prophet's interpretations and explanation of revelation and also through his own exemplary conduct. For example, the rules about prayer and *zakat* as contained in *hukm 'ibadat* represent the Prophet's sunnahs taught to his followers in practical form as the Quran does not lay down their details. *Ijma'* is essentially personal opinions of an individual scholar when it receives universal acceptance of the Community. *Ijma'* and *Qiyas* (*Ijtihad*) are therefore two complementary factors, i.e. the continuous process of *Ijma'* requires an initial exercise of independent thinking or *Qiyas*. Therefore, the interaction of *Qiyas* and *Ijma'* is essential in Islamic legislation. They are, according to Ahmad Hassan, "instruments or agencies for legislation on new problems for whose situation a direct guidance from the Quran and *Sunnah* is not available ... an authoritative source of law being subservient to the Quran and the *Sunnah*¹⁸." Having discussed the nature of *hukm shari'ah*, the next section explains how it is related to economic modeling.

6. Islam and Economic Modeling

A theory is an abstract representation of the real world. It is used to guide economic agents to solve economic problems which can either imply making predictions about future economic outcomes or explaining past economic events. Therefore, an established theory is regarded as an economic law or principle and thus can be widely used to guide economic decision making. A well-known example is the theory or the law of demand according to which price and quantity demanded of a product are inversely related. Such relationship assumes other explanatory variables as constant, without which one could not distinguish which variables influence demand,

one at a time. The role of assumptions in economic theory is therefore, crucial. It is a critical element of a theory.

The construction of economic theories in conventional economics is well-said in many basic economic textbooks¹⁹. It begins with developing a model that consists of a list of assumptions. A model is a simplification of reality and by no means an absolute truth to explaining economic behaviour. These assumptions that may be behavioral and structural in nature, represent the central issue of many debates on economic methodology. For instance, the Samuelson²⁰ requires each of these assumptions to be tested empirically, for any theory is deemed useless if it is based on some unrealistic assumptions about the real world. On the contrary, Friedman²¹ insists that such empirical proofs are not necessary as long as the theory can make accurate predictions.

Through economic model, certain hypothesis can be empirically tested. Similarly, the model can also be used for prediction. But when the prediction is found to conflict with facts, either the theory is to be rejected or some modifications are made to be made to the model. These modifications may include reformulating the model's variables, assumptions and hypothesis leading to creation of a new model. In this sense, an economic principle is derived from experience alone and has less bearing on models' assumptions.

In Islam some economic principles can be derived from the *shari'ah*. These principles represent the hard core of Islamic economics. We intend to name them the *first-level principle*. The other source of economic principles in Islam is economic theory that we call *second-level principles*. Since economic theory is a study about human behaviour, the construction of an Islamic economic theory is expected to contain elements of *shari'ah law*. The question now, what is the role of *shari'ah law* in model building?

In Islamic theory building, *inter alia*, the researcher's main concern is about developing an economic blueprint of the economy that is not found in the Quran. The Quran provides legal and also ethical principles about, say consumer behaviour. For instance, in legal terms, the consumer is prohibited (*haram*) to enter a transaction in which the elements of doubts and irregularities (*gharar*) prevail. In ethical term (*akhlak*), he is enjoined to practise moderation in spending. However, the Quran does not provide

consumption or investment theory. Neither it gives forecasting nor projection techniques that are important ingredients in macroeconomics models and economic engineering. The Quran only lays down foundations or general principles about the behaviour of economic decision makers. These foundations of economics are assumed given so as to follow what is practised in mainstream economic textbooks and they form an Islamic economic system. Basically, an economic system is a set of rules and regulation for solving problems of resource allocation, stability and growth. It consists of rules and regulation about ownership, decision making, implementation of decisions and motivation²². The Islamic jurists represent the institution responsible for defining the character of the economic system and make Quranic economic injunctions into a systematic economic entity. Thus, one can say that the role of the economists in Islam is to study the implications of various Sharia' based-economic systems as economic theories and used them in developing economic blueprints. In other words, while the Islamic jurists lay down the economic system, the economists prepare the economic blueprints.

As mentioned earlier, a theory is a causal relationship between two and more variables. It is a logical relationship between facts. As an economic theory involves systematic facts that characterise human behaviour it cannot be alienated from the Shari'ah. But such links may not give an Islamic economic theory scientific stature as the role of revealed values in theory building is inevitable in Islam. But this is not our main concern. Scientific inquiries are most relevant in the natural (*tabi'*) sciences such as biology, physics and chemistry. They involve experiments that guarantee repeatable results and give accurate predictions of outcomes by a mere fact that experiments are controlled. Scientific discoveries in this sense are therefore *hukm tabi'* or the manifestation of natural law. The role of scientists is to discover these laws so that science and technology can progress for the betterment of humanity.

But science is not the only source of knowledge in Islam. Scientific knowledge according to Al-Ghazali is derived from two sources, namely '*ain-ul-yaqin*' and '*ilm-ul-yaqin*'. The former refers to the knowledge derived from sense perception, namely material (*Isman*) and facts (*Haqiq*) whereas the latter are based on reasoning and human judgement (*Khayali* and '*Aqli*'²³. But, the scientific method is deficient when knowledge about principles of human behaviour is involved in a discipline such as economics. Therefore, to assign a paramount role of science in economics is misleading

when Islam is concerned. This is because the ultimate source of knowledge in Islam or *Haqq-ul-Yaqin* is in divine revelation (*wahy*) in which many rules and guidelines about economic behaviour are given²⁴. However, the scientific method remains important in theoretical construction in Islam and will not jeopardise the inherent role of *shari'ah* in modeling.

7. Shari'ah law and *hukm tabi'* : An interaction

First, some explanation of *hukm tabi'* is necessary. The literal meaning of *tabi'* or *tabi'at* is natural²⁵. In this sense, *hukm tabi'* can be classified into two. The first type refers to the innate behaviours of all creations which Al-Farabi classified as *al-'ilm al-tabi'i*. It deals with principles of natural bodies, principles of the elements and simple bodies, generation and corruption of natural bodies, reaction with element undergoes to form compound bodies, properties of compound bodies, minerals, plants, animals, including man²⁶. In humans and animals for example, these innate behaviours include the desire for food, companions, love protection, power etc.

However, fulfilling these innate basic needs requires additional guidelines which are defined in the value system adopted by the agents involved. Take for example the desire for food which will result in economic transactions. The desire for food and the subsequent act of consuming food is *hukm tabi'* of the first type. However, the consumer is subject to some rules of behaviour when undertaking consumption such as what food he can take and the means of obtaining the food, i.e. contract of exchange. In Islam, these rules of behaviour are defined by the *Shari'ah*.

The second type of *hukm tabi'* emerged when one wish to find out what factors determines the demand for food which in fact is demand theory itself. This type of *hukm tabi'* depends on facts and some behavioral elements which are *Shari'ah* based and therefore, create a consequential phenomenon²⁷. In other words, it is based on the outcome of individual behaviour. Based on this consequential component of *hukm tabi'*, one can extract more information about consumer behaviour through economic concepts like price, income and cross elasticities which prove to be useful in sales and marketing. Furthermore in economics, there are phenomena which describe the behaviour and characteristics of the production process such as law of diminishing returns, opportunity costs, economies of scale, return to scale, specialization and many more. These phenomena are the

invest via equity-based or *Musyarakah* system where business risk is shared by all parties involved. The zakat system also plays an important role to ensure low liquidity in the banking system since zakat is levied on net current assets. Thus, banks' reluctance to invest in favour of holding cash reserves will only end with depleting assets over time.

However, the above hypothesis only holds under certain assumptions. Without making assumptions, it is impossible to isolate important factors from those deemed insignificant to the model. Making wrong assumptions may however put the hypothetical statement in a straightjacket since they may not follow the logical and deductive arguments in support of the hypothesis. Therefore, putting a right assumption to support a particular hypothesis is crucial.

In Islamic theoretical building, the role of assumptions is just as important as in conventional norms. In the investment model, some assumptions may be made both under *shari'ah* and through observation which are summarized as follows:

TYPE 1: Assumptions based on *shari'ah* law:

- i) No interest-based debt financing.
- ii) The *zakat* system is applied to the financial sector.
- iii) No *gharar* transactions.

TYPE 2 : Assumption based on observation (*Hukm Tab'i*)

- i) Perfect competition.
- ii) Firm can obtain capital at market price³⁰.
- iii) An equity-based profit-loss sharing system prevails in all financial institution.
- iv) Equity-based investment or *Musyarakah* represents the bulk of business spending i.e. *Musyarakah*/*Mudarabah* exceed *Murabahah*, *Bai-bithamin-Ajil* and *Ijarah* instruments.³¹

Being based on *shari'ah* law, the Type I assumptions are not subject to changes even if the empirical result shows that $b_1 < 0$ ³². (However if $b_1 < 0$, the findings can be used to justify more fiscal or monetary incentives to the private sector to boost investment spending). In conventional practices, contradicting result as the above, requires explanation and these

are often related to wrong assumptions. For example, Leontief's pioneering study of the U.S. pattern of trade in 1936 shows that U.S. export labor intensive goods while imports are capital intensive³³. The results did not conform to the established Heckscher-Ohlin trade theory which predicts otherwise. This study which produced the well-known *Leontief Paradox* has stimulated immense scholarly debates about the assumptions made in the model which include no factor intensity reversal and constant returns to scale in production. Several empirical tests were undertaken to study the above two assumptions. The results of these studies showed that both assumptions do not hold in international trade of some countries³⁴. In fact, assumptions are usually subject to empirical investigation to explain why unexpected results such as the *Leontief Paradox* occurred. These assumptions are sometimes modified to make way for new ones to explain why a hypothesis is not in line with reality³⁵.

However, such an approach above may not hold in the Islamic economic methodology. This is because *shari'ah*-based assumptions are divine and remained unchanged irrespective of changing circumstances. It therefore implies that these assumptions are not subject to empirical tests i.e. no compromise between reality and Type 1 assumptions is expected. For example, when $b_1 < 0$, the researcher is not expected to propose introducing a new instrument such as interest rate or *riba* into the financial system to ensure that the relationship between investment spending and profit rate is established as hypothesised earlier. Also, if the researcher feels that the market is overregulated and caused investment and profit to behave unexpectedly, he is not expected to recommend the abolishment of *zakat* which he thinks may be the prime factor causing the problem. In other words, the hypothesis in the model only serves to explain and predict economic activities in which values and economic behavior were based on *shari'ah law* and *hukm tabi'* in society. A hypothesis is not a divine revelation for it only tries to explain the implications of human action whose value-system is *Shari'ah*-based in causal terms. Therefore, the researcher should avoid making the hypothesis more superior to the *Quranic*-based assumptions by subjecting the latter to modification.

On the contrary reality must conform with the Type 1 or *shari'ah*-based assumptions and not otherwise. When investment spending is found negatively related to profit-rate, the researcher in Islam must take a critical look at Type 2 assumptions which are subject to falsification. This is because Type 2 assumptions are based on real world observation or

sometimes partially observed events such as the maximizing behaviour assumption. As such, the problem may either be caused by specification error in the model which requires the researcher to either redefine the types of variables used in the model or exclude the irrelevant ones and introduced some new ones. If results are contrary to the common belief, the researcher then modify the equation that may help improve the model. The problem may be due to the imperfect implementation of the *shari'ah* in the state which can be remedied by the authorities through proper education reform. For example, the problem may lead the researcher to discover that most firm have involved trading-based instruments by using *Murabahah/Bai-Bithamin-Ajil* instruments instead of equity-based technique such as assumed by the model because bankers and depositors are not well acquainted with the profit-loss sharing system.

Therefore, it can be observed that in Islam, the construction of economic theory is in line with scientific method when Type 2 assumptions are concerned. That is, empirical test undertaken in Islam is based on facts and intends to explain these facts in terms of law. On the contrary, the nature of Type 1 assumptions which are based on *shari'ah* remain intact as they represent the economic system and remain in that special position even if a particular hypothesis or established theory is found to contradict reality. It is here the knowledge of right and wrong is embodied in modeling for which the source is revelation. Therefore, the Islamic methodology in economic modeling can enlighten what science has failed to accomplish, that is putting values of human behaviour as specified in *shari'ah law* in a superior position over observed values as manifested in *hukm tabi'*. The study of human behaviour in the secular sense only concerns how humans do behave which have direct bearing on their overt activities. This means that human values in mainstream economics are essentially scientific which is true. Due to their secular way of life, truth comes from reality only. But this does not imply that the scientific method is value free. In fact, when the scientific method is imposed on the study of human behaviour by the West, such as in economics, one can conclude that such imposition of western value i.e. the truth is based on sense experience alone, has in fact made the study of human behaviour less scientific. In the same vogue, the role of revelation in determining human values in Islam is the core of the religion and remain paramount in model building. Hence the proper role of science in Islam is to reaffirm truth of revelation. For example, the reason behind the prohibition of *Riba* is that it represents a form of unfair business transaction. Science must therefore show that all forms of *riba*-based

transactions have caused misery to the poor as their wealth is eroded by rich creditors and bankers through *riba*-based debt financing. Hence, any theory discovered is expected to explain the rightful place of revealed knowledge in economic modeling and the economic implication of Quranic-based behaviour. In this sense only, one can see how economic theories in Islam are found to conform and form a new frontier of knowledge.

8. Conclusion

The paper has argued that in Islam, economic activities are guided by two main principles, namely revealed and observed principles. Revealed principles determine what is right and wrong about economic behaviour which involve the interaction of belief, ethical and legal injunctions of the Quran. On the hand, observed principles guided man to plan, forecast, predict and therefore lay down strategic blueprints to overcome basic economic problems. These principles or economic theories which are based on facts about past economic behaviour are also Quranic based. It is argued that an economic theory in Islam is a source of economic principle after the Quran, Sunnah, Ijma, Qiyas and Ijtihad which therefore, implies the development of Islamic economics as a discipline should not dwell around economic system alone but economic theory as well. However, applied model building in Islam is difficult to exercise now because hardly any country in the world today implement and fully practice Islamic law in the economy.

End Notes

1. By scientific values we mean values derived from sense experience i.e. reasoning and facts. However this does not imply that scientific values are alien to the Quran. In fact the Quran enjoins scientific endeavors (See *Al-Anfal*:22; *Al-Isra*':36; *Al-Ghasyat*h:17-20). Quranic values implies Quranic legal and ethical injunctions which only governs human behaviour.
2. Mohammad Fahim Khan, "Theory of Consumer Behaviour in Islam", in S.Tahir, A.Ghazali and S.Omar (eds.) *Readings in Microeconomics: An Islamic Perspective*, Longman, Kuala Lumpur pp. 69-80. Similar approach was made by M.A. Tahir and B. Shari. See their article "The Formulation of Consumer Demand Models in Islamic Economics", in A.R. Moten and

- B.Shasi (eds.) *Nature and Methodology of Islamic Economics*, Bayero University, Nigeria 1990. pp. 186-204.
3. M. Metawally, "A Behavioural Model of an Islamic Firm", in S.Tahir, A.Ghazali and S.Omar (eds.) *Readings in Microeconomics: An Islamic Perspective*, Longman, Kuala Lumpur pp. 131-138.
 4. R.L. Heilbroner and L.C. Thurow *The Economic Problem*, Prentice Hall, New York, 7th Edition. 1983. pp. 85-92.
 5. Muhammad Amran Khan, "Methodology of Islamic Economics". in A.R. Moten and B.Shasi (eds.) *Lectures on Islamic Economics*, Islamic Research and Training Institute and Islamic Development Bank, Jeddah 1992. pp. 93-100.
 6. Mohammad Anas Zarqa, "Methodology of Islamic Economics", in Ausaf Ahmad and K.R. Awam (eds.) *Lectures on Islamic Economics*, Islamic Research and Training Institute and Islamic Development Bank, Jeddah 1992. pp. 93-100.
 7. S.N. H Naqvi, *Ethics and Economics: An Islamic Synthesis*, The Islamic Foundation, Leicester 1981.
 8. Muhammad Anwar, "Islamic Economic Methodology", in A.R. Moten and B. Shasi (eds.) *Nature and Methodology of Islamic Economics*, Bayero University, Nigeria, 1988.
 9. A.R. Moten and M.O.K. Bajulaiye-Shasi (eds.), *Nature and Methodology of Islamic Economics*, Bayero University, 1988, pp. 285-305. The statement is taken from a chapter titled, "A Manual on the Methodology of Islamic Economics", in which no authors can be identified. The writer assumes these were resolutions made in the Conference in which editing works were undertaken by Moten and Shasi.
 10. Literally, the word *shari'ah* means a "course to the watering place" or a "resort of drinkers". The Quran uses the word *shir'ah* and *shari'ah* in the meaning of *din* (religion), in the sense that it is the way ordained by God for man. The term *shara'* (pl. of *shari'ah*) was used in the Prophet's time for the essentials of Islam. In this sense, *Sharia'h* is not *Fiqh*. According to Qadri, *Sharia'h* "means a complete code of faith and practice, i.e. of *'aqa'id* and *a'mal*, and its first divided elements are *'ilm-ul-Kalam*, or the science of unity and attributes of God, *Islah-al-Zahair* of *fiqh*, and *tasawwuf* of internal manifestation". For more details see, Anwar Ahmad Qadri, *Islamic Jurisprudence in the Modern World*, Lahore, Pakistan, 1973.
 11. *Hukm* (pl. *Ahkam*) means value. However, the word *law* will be used instead of *hukm* to avoid unnecessary confusion. The usage of the term *hukm* is meant to emphasize the legal values economic laws contained in the Quran and refined in *fiqh* literatures into that of *wajib*, *sunnat*, *mubah*, *makruh*

- and *haram*.
12. As explained in footnote 11, the *Shari'ah* is not *fiqh* or legal rules. The author used the term revealed principles for *Sharia'h* to show that the *Shari'ah* is not a code of law but contain principles governing man's belief and ethics.
 13. Fazlur Rahman, "Law and Ethics in Islam", in A. Hourani (eds.) *Ethics in Islam*, University of California Press, Berkeley, 1984.
 14. The author used the term *hukm shari'ah* instead of *Shari'* to point that in economics, economists talk about facts in term of laws. Moreover, *shari'* or *shari'ah* in our usage is not *fiqh*. *Shari'ah* covers all aspect of Islam comprising of *Kalam*, *Akhlak* and *Fiqh*. According to Asaf Fayzee, "*Shari'ah* is the wider circle, it embraces in its orbit all human actions; *fiqh* is the narrow one, and deals with what is commonly understood as legal acts. The path of *Shari'at* is laid down by God and His Prophet; the edifice of *fiqh* is erected by human endeavor". For more details see, Asaf Fayzee, *Outlines of Mohammadan Law*, London, 1960. However, in our article, *ilm fiqh* is referred as *hukm amallah* which is classified into *hukm 'ibadat* and *hukm muamalat*.
 15. A.Majid Khaduri, *Islamic Legal Philosophy*, Islamic Research Institute, Karachi, 1976.
 16. For detailed discussion on *hukm shari'ah* see, Mukhtar Yahya and Factchurrahman, *Dasar-Dasar Pembinaan Hukum Fiqh Islam*, Al-Ma'rif, Bandung, Indonesia, 1986. Also see, M. Hasbi Ash Shiddiqy, *Falsafah Hukum Islam*, Indonesia, 1983.
 17. This statement is extracted from *Riya' Usul al-Din*, vol. 1 according to which someone reported to Abu Hanifa that his disciple, Abu Yusuf, was resorting to the morally questionable practise of evading payment of zakat by transferring his property to his wife before it has had been in his possession a whole year, as required by the law of zakat, and his wife did the same with her property.
 18. Ahmad Hasan, *The Early Development of Islamic Jurisprudence*, Islamic Research Institute, Islamabad, 1970, pp. 42.
 19. A good and simple discussion on economic methodology is given in Richard G. Lipsey and Peter O. Steiner, *Economics*, 4th edition, Harper and Row, New York, 1975, pp. 18-42. For more interesting discussion see mark Blaug, *Economic Theory in Retrospect*, Chapter 9-11.
 20. Samuelson, P., *Foundations of Economic Analysis*, McGraw Hill, New York, 1947/65.
 21. Friedman, M., "The Methodology of Positive Economics", in *Essays in Positive Economics*, University of Chicago Press, Chicago 1953.

22. Stuart, Gregory. *Comparative Economic System*, Prentice-Hall, New York 1986.
23. For further details, see Muhammad Umaruddin. *The Ethical Philosophy of al-Ghazali*, Lahore, 1970, pp. 112-129.
24. Ibid., pp. 121-122.
25. Elias A. Elias and Ed. E. Elias, *Elias' Modern Dictionary Arabic-English*, 11th. edition, Edward Elias, Cairo 1976.
26. Osman Bakar, *Classification of Knowledge in Islam: A Study in Islamic Philosophies of Science*, Institute for Policy Research, Kuala Lumpur 1993, pp. 123.
27. This consequential aspect of *hukm tab'* is *shartah*-based. A demand theory is Islamic when the underlying assumption of the theory has some legal content. For example, all products must yield *manfaat*. Contract of exchange must not contain elements of *gharar*.
28. For further details on the anti-cyclical behaviour of *musyarakah* or equity-based financial instruments, see author's article, "Welfare Implication of Interest-free bank Asset Management", *Journal of Islamic Economics*, Vol. 2, number 2, July 1989.
29. This model is based on the Post-Keynesian profit/liquidity theory of investment in which optimal capital stock is some function of expected profit. Expected profits in turn, are some function of actual profits in the past. For further details, see P.M. Junankar, *Investment: Theories and Evidence*, Macmillan, London 1981, pp. 28-37. However, the Islamic version presented in this paper has no Islamic theoretical foundations of mathematical elegance. But this is not our concern because theory is not the main source of hypotheses and models. Theories from other social sciences, researcher's intuition, received wisdom, regularities and trends actually or allegedly observed in real life, "gut felling", etc can all contribute towards building an econometric model. The purpose of introducing the profit theory of investment in merely a case to show applied models in Islam are used to help man solve their economic problems according to Quranic injunctions.
30. This assumption is based on recent observation of Islamic banking practice in which preference is given to trading-based (*Murabahah*, *Bai' Mua'jjal*) instead of production based instruments such as *Musyarakah* and *Mudarabah*. Such practice however has diverged from the early model of Islamic banking which put high emphasis on profit-loss sharing principle between bank and business. Failure to do so would make Islamic banking no difference to conventional practice as far as the procyclical tendencies in fund management are concerned. For further details, see the authors

- article "Welfare Implication of Interest Free Bank Asset Management", *Journal of Islamic Economics*, Vol. 2 number 2, July 1989.
31. Zakat on business is 2.5% of the zakatable assets of the business. Zakatable assets are the value of net current assets as shown in the balance sheet. For example, in Bank Islam Malaysia Berhad Annual Report 1993, current assets for zakat include cash and balances with banks and agents, stock of commodities and investments. Current liabilities include deposits from customers and deposits and balances of banks and agents. The difference between these two entries gives the value of net current assets. On the asset side, investments in Mudarabah, Musyarakah and other trade related instruments are expected to generate some rate of profit. Suppose rate of profit is 10%. As zakat on these assets is 2.5%, the net profit from investments would be positive. But if the bank chooses to keep high amount of idle balances due say, a bad recession, the net gain from cash holding will be negative as the bank has to pay zakat of 2.5% on these cash balances which also generate zero rate of return. Thus in banking, holding high level of cash balances or excess reserves is unproductive and zakat can be looked upon as a deterrent against such inefficient use of funds. In other words, zakat indirectly penalises banks with high liquidity ratio. To avoid cash based assets from further depletion, Islamic banks are expected to use more aggressive and efficient methods in fund management to maintain some reasonable level of liquidity.
30. Muslim writers have not agreed to any general technique of determining the price of capital in an Islamic economy. Profit rate and some profit-sharing ratios were proposed (see M.N. Siddiqi, *Issues in Islamic Banking*, The Islamic Foundation, London 1983, pp. 97-112 and F. Khan, *A Simple Model of Income Determination, Growth and Economic Development on the Prospective of an Interest-Free Economy*, The 3rd. International Conference on Islamic Economics, International Islamic University, Kuala Lumpur 1992). However, these suggestions were problematic since a high profit-sharing ratio may not attract investors if the firm's past performance was disappointing. Similarly, the offering of low profit-sharing ratio (lower profits to firm and higher to investors) by well-known successful companies may not deter potential investors.
31. In modeling, the researcher must assume certain conditions to prevail to ensure some logical consistencies in deductive reasoning and hypothesis testing. The assumptions must be a close approximate of reality. The accuracy of the model, hence depends on how realistic are the assumptions.

The *shari'ah* based assumptions given in the modeling example are in fact real life legal rules governing these two variables which explain actual Muslim behaviour.

32. Leontief, Wassily, "Domestic Production and Foreign Trade: The American Capital Position Re-Examined," *International Trade*, ed. Jagdish Bhawgwati, Baltimore, Penguin Book, 1969.
33. Minhas, B.S., "The Homohypallagic Production Function, Factor-Intensity Reversals and the Heckscher-Ohlin Theorem", *Journal of Political Economy*, 1962.
34. To make theories scientific, assumptions are subject to falsification test. This means that the economic theories must avoid axiomatic and tautological tendencies. But due to man's ignorance of truth, economists resorted to axiomatic method of understanding human behaviour. The axioms of *consistency and completeness* represent the foundations upon which the rational economic man behaves. These assumptions are not testable. However in Islam, the Quran provides information about true human character. How a Muslim should behave is clearly spelt out in terms of legal and ethical injunctions. In this sense, there is relatively less economic ignorance in the Islamic view of man.