Corporate governance in Islamic perspective

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Abstract

Purpose – The purpose of this conceptual paper is to develop a discussion expounding the Islamic perspective of corporate governance as a special case of a broader decision-making theory that uses the premise of Islamic socio-scientific epistemology. Islamic epistemology is premised on the divine oneness of God. The worldly explanation of divine unity is done by means of specific laws and instruments that make the Islamic epistemology functionally viable in developing, implementing and inferring from the application of the epistemological rules to different issues. In the present case the issue is of corporate governance.

Design/methodology/approach – The development and conclusions of this discursive paper as a conceptual one point out the possible application of a process-oriented epistemology of unity of knowledge to corporate governance. The underlying methodology of institutional discourse and integration with dynamic parameters is formalized.

Findings – The end results of the conceptual framework of this paper on corporate governance are contrasted with the approach to corporate governance in mainstream literature. Also the same Islamic theoretical and philosophical background of corporate governance is examined from the dual (mixed) Islamic economic and institutional perspective.

Practical implications – The practical implications of the Islamic idea of corporate governance are immense in studying transaction cost minimization in decision-making environments. In this regard it is argued that the theory of Islamic corporate governance presents a discursive process, transparency and institutional participation that reduce transaction costs.

Originality/value – The paper contributes fresh knowledge in corporate governance theory in the light of two central issues. First, an organic preference formation is studied by a process model. Second, transaction cost is minimized while pursuing a discursive and participatory model of decision making in an environment governed by the systemic meaning of unity of knowledge as its episteme. Relevant institutional policies can be developed in the light of such systemic discursion under the episteme of unity of knowledge understood and applied in the systemic organic sense.

Keywords Corporate governance, Islam, Financial economics, Epistemology

Paper type Conceptual paper

In this comparative conceptual paper on corporate governance between Islamic and mainstream orientations on the topic we undertake an epistemological approach in establishing the foundational concepts of corporate governance in Islam. In undertaking the epistemological approach we derive the process-oriented discursive methodology of perpetual learning in organizational and systems behavior that emanate from the premise of unity of knowledge. In the broadest Islamic precept the overarching episteme is that of oneness of God. In the systems methodology the emanating derivations from the precept of oneness of God is expressed as oneness of divine knowledge. It expresses itself and explains phenomena in the framework of perpetual knowledge production. This generates systemic learning by discursion and universally complementary relationships between the entities of world-systems and their embedded institutions. In our
case the specific category of such an embedded polity and entity is corporate governance in Islam.

**What is corporate governance?**

What is corporate governance as conventionally understood? What is corporate governance in the Islamic perspective under the epistemological methodology of unity of divine knowledge on which all of Islamic scholarship is premised? Answers to these questions are first divulged here.

**Corporate governance as a mainstream organizational concept**

Corporate governance has to do with those legal and organizational structures that look after the internal integrity of a corporation. The implication here is that a corporation is an organization and hence an institution. It is thereby a bundle of contracts and rules under which it functions, is legitimated by legal enactment and protected by the legal tenets of any government and state. The implications of such legal obligations and protection may be limited nationally or extended internationally under agreed upon globalization rules.

The latter case forms the extension of the legal statutes and conditions of property rights to the international venue by WTO governance policies such as TRIPS (Trade Related Investment Property Rights), TRIMS (Trade Related Investment Measures), Surveillance and Dispute Settlement Mechanisms, environmental protection, antidumping, corporate transparency, corporate responsibility, equitable distribution of wealth and income, labor laws and many others. As the complexity of the business environment in relation to property rights issues expands, the network of interrelationships among such diverse points of the complexity system grows. In the end there can hardly be anything left out of the extended meaning of corporate governance, though the discernible identification of such governance methods, tools, organization and acceptance go through an evolutionary learning process (Jensen, 1993).

Corporate governance as an organizational concept can be derived from the words of Arrow (1974, p. 224) who writes:

> An organization is a group of individuals seeking to achieve some common goals, or, in different language, to maximize an objective function. Each member has objectives of his own, in general not coincident with those of the organization. Each member also has some range of decisions to make within limits set partly by the environment external to the organization and partly by the decision of members. Finally, some but not all observations about the workings of the organization and about the external world are communicated from one member to another.

**The objective function of corporate governance**

The very first objective of corporate governance is to define and attain an objective criterion by means of understanding the relations between critical variables supported by policies, programs and strategic coalitions. The last point leads to the determination of rules of actions, policies and strategies by means of institutional consensus and the exercise of proper instruments as required by the kind of corporation in action. Thus there are three stages involved in the determination of the groundwork of corporate governance. First, there is the collective formulation of objective criteria. In view of the complex nature of networking in corporate governance there must inevitably be multiple objective criteria interlinked in some explainable way.

We define such an objective criterion function as:

$$ W = W(x, p; \theta) $$

$x = \{x_1, x_2, x_3, \ldots, x_n\}$ denotes a vector of socio-economic variables between which interrelationships must be studied with respect to market and environing realities. For example, $x_1$ can denote price of good 1, $x_2$ as price of good 2, $x_3$ as the quantity of good 1; $x_4$ as the quantity of good 4. The relationships between these happen through the interaction between demand and supply of such goods in multimarkets (here two markets).
\( P = \{ P_1, P_2, \ldots, P_m \} \) denotes the vector of policy variables and instruments. An example is of \( P_1 \) as competition policy, \( P_2 \) as corporate transparency; \( P_3 \) as a management contract with labor on wages and job security.

\( \geq \) denotes strategic preferences of corporate members either in management hierarchy or in co-operative mechanism within team work. The latter kind of strategy can be found in Japanese firms (Kobayashi, 1988). An example is that in order to determine right multimarket prices using the policies of corporate governance as mentioned above, the preferences of the corporate members would be different between competitive markets (the Taylor model of corporate governance) and co-operative strategies (Japanese case).

\( \theta \) denotes a consensual value of discursive mechanism existing within the corporate organization either in its hierarchical form or co-operative form to establish the preference \( \geq \). Hence we write \( \geq \) as being functionally determined by \( \theta \). That is \( \geq (\theta) \), which is a key epistemological indicator in the organizational theory of the firm. The structure, and thereby the nature of corporate interrelationship in the specific firm, will be determined by the kind of behavioral preferences formed by the discursive mechanism. In a neoclassical firm competitive behavior will rule foremost. In the co-operative firm complementary relations between multimarkets and the organizational strategies will prevail.

**Comparison between Herbert Simon and Kenneth Arrow’s organizational theories in the light of corporate governance theory**

Simon (1960) referred to the above kind of simulative approach to decision making in a firm as satisficing behavior. According to Simon there are three phases of decision making at the organizational level. The first phase is the intelligence activity. This accounts for setting up the favorable conditions for decision making. The second phase is the design activity. This accounts for searching, discovering and analyzing possible sets of ways and means of interacting with the design activity. The third phase called the choice stage engages in selecting and implementing particular choices of actions that have been discovered and analyzed at the stage of design activity.

Simon’s characterization of an organizational conception of the firm is more process-oriented than Arrow’s. In Arrow’s characterization there is a particular conception of preferences that reside with competing individuals somehow molded together to form the preference of the organization as a whole. Such a hierarchical preference formation then enters the criterion function of the organization. The maximization behavior along with the competing preferences of individual members makes the preferences those of self-centered individuals, whose individualistic preferences are then molded in ways unknown.

First, such a molding results in lateral aggregation of individual preferences. Then this method of preference aggregation turns out to be simply an analytical nicety of civil libertarianism (Bentham, 1789) rather than a process that explains formation of consensus. The assumption underlying this kind of preference aggregation is that every individual behaves alike and unanimously concedes to a unique preference (Harsanyi, 1955). Despite accepting an argument sometime premised on the capacity for happiness in utilitarian ethics, a convergence to such a unique preference by the methodical rule of lateral aggregation raises the problem of idealism against political realism.

Second, such a convergence of preferences can happen by the hegemony of a dominant ruler. This is the kind of decision making that takes place in any form of democracy where the will of a majority voter wields the power of convergence. The same kind of behavior when extended to international affairs would mean the reign of the will of a certain powerful group over the rest. In the economic scene the transnational companies have governance over the command of resources and investments in developing countries. Such policy governance is done by the WTO using the policy instruments of TRIPS, TRIMS, and capital-accord in FDI movements and capital accounts liberalization. The technological dominance of the industrialized nations over the submissive will of the developing ones marks the return of Eurocentricity as a form of institutional governance in the globalization scene (Amin, 1989).
Selection of corporate strategies: the social wellbeing criterion function

Whether it is the maximization or the satisficing nature of the criterion function, the corporation selects its strategies, and thus has a perspective of the relationships governing \( x \) and \( P \). Here too the behavioral factor in preference formation is critical. If the preferences are of hedonism and methodological individualism governing individuals, institutions, organizational behavior and markets, then our earlier selection of the market variables for \( x_1, x_2, x_3, x_4 \) in multimarkets will show relationship between these markets by way of marginalist tradeoffs. Underlying this perspective of mainstream economics is the pervasive idea of resource allocation between competing ends. It stems from the neoclassical economic roots of the principle of marginal rate of substitution as the governing principle of competition linked with scarcity and both methodological individualism and independence between competing agents and alternatives. Corporations adopt this principle to govern over alternatives that they assume are faced by the fundamental pre-condition of scarce resources in economic production. The bundle of policies that they adopt, namely intensifying competition \( (P_1) \), evade competition policy \( (P_2) \) and exercise control over international resources \( (P_3) \) by taking protection of the trade and capital-flow liberalization instruments of the WTO and the IMF as mentioned earlier.

The following kinds of relationships will apply between the socio-economic and policy variables that we expect in the two cases of Arrow’s individualism and Simon’s satisficing behavior of agency.

1. Kenneth Arrow

\[
x_i = f_i(x_i', P_j) \quad i = 1, 2, 3, 4; \quad j = 1, 2, 3
\]  

where \( x_i' \) denotes the \( x_i \) variable without the \( i \)th one

In corporate governance a strategy to acquire oligopolistic control of market shares will cause \( x_i \) as price or quantity variable to be determined by the price and quantity based collusion approach (Martin, 1988). Expression (2) forms a system of equations.

\( P_j \) could then denote policy variables such as anti-trust law, competition policy and advertising. The anti-trust policy could be measured by the rate of change of copyright violation as a function of one business output in terms of another. Competition policy could be measured by the rate of change of profits above a critical level as a function of one business output in terms of another. Advertising policy is measured by the expenditure in promoting sales, and is thereby a function of one business sales value relative to another one toward gaining market access.

In each of such relations we note that there is an intrinsic condition of tradeoff, and hence, marginal rate of substitution due to competition between the firms to gain market shares and market access. All strategies revolve around such a pre-condition. The overarching preference formation governing decision making in the corporation is thus premised on the principle of marginal rate of substitution as a tradeoff caused by the assumption of competition in the oligopolistic model of corporate governance. Consequently, the causality between the variables and their relations in the system (2) would be based upon and reflect this tradeoff and competing behavior.

2. Herbert Simon

Now the system of expressions in (2) remains intact, except that the preference formation is institutionally driven rather than market driven on the assumption of marginal rate of substitution, and thus tradeoff and competition. The policy and strategy variables become more important in causing a pattern of the socio-economic variables to emerge.

In the organizational theory of the firm given by Simon (1957) there is an internal social process within the organization that links up with the socio-economic variables. Information about the market environment and strategies remain incomplete. Hence agents are not optimally rational as in the case of Arrow. Thus bounded rationality defines agent-specific behavior in economic and policy choices.
Three kinds of interaction apply in Simon’s organizational decision-making behavior.

\[
\begin{align*}
R_1 & : \text{intrafirm interaction} \rightarrow \text{cohesion (C)} \\
R_2 & : \text{C} \rightarrow \text{Diversity of strategies and decision (D)} \\
R_3 & : \text{D} \rightarrow \text{C (recursive decision making)} \\
R_4 & : \text{C} \rightarrow \text{I}.
\end{align*}
\]

(3)

The continuity of \(R_1 \rightarrow R_2 \rightarrow R_3 \rightarrow R_4\) (4) is based on the competition theory of the firm that remains linked to markets. Such a firm’s behavior being premised on competition and tradeoff, the recursive relations intra-organization build upon this assumed form of competing behavior of the firm and reinforces the same through similar policy prototypes.

Simon’s organizational theory of the firm is simply an institutional enforcement of the process internal to itself that derives from and then enhances the neoclassical hypothesis of marginal rate of substitution as information evolve within a bounded rationality set of alternatives. Simon’s methodology is thus an extension of Arrow’s organizational maximization problem to institutional preference behavior.

Feedback loops in decision making for corporate governance: the enironing factors

The enironing factors of corporate governance are of two kinds, socio-political and politico-economic. There are interactions between these factors, particularly in the light of Simon’s organizational theory of the firm. They generate significant consequences. In other words, a corporation in the organizational theory of the firm should be seen as a social and economic organism.

In the socio-political case the corporation is to be seen as a socially responsible organism. Some of the reflexive preference behavior of the corporation would be creating jobs, sustainable development and goodwill in sales. But to attain such goals the corporation needs to exist and grow as a dominant supplier. The production levels and acquisition of market shares between these large and small enterprises have important consequences. The dominant supplier determines the residual supply and demand curves of the small enterprise outputs. Small enterprises are unable to recover the average cost of production that otherwise the large firms can face due to their diseconomies of scale. Consequently, an adverse pricing situation arises. In this scenario the dominant corporate supplier manages to price its products down to the limiting pricing level. But for the small enterprises this would mean bankruptcy (Martin, 1988).

In the political economy of corporation as a social and economic organism in relation to the enironing factors, an important issue to treat is sustainability. Transnational companies are proven to be irresponsible adventurers and rent-seeking producers in the resource-rich hinterland of the developing world (Trainer, 2002; Tisdell, 2002). Thus corporate governance means legal constraints, penalties and rewards, transparency and disclosures on the operations, revenues and expenditures. International anti-trust and competition policies are required to govern oligopolies, cartels, acquisitions and mergers.

In respect to the enironing factors a recursive feedback relationship of the type shown in expressions (3) and (4) now requires active policy variables \(P\) as in the system of relations given by (2). But since the organizational theory of the firm is linked with the economic rational theory of a profit-maximizing firm, a corporation finds its preference formation to be in the midst of contrasting forces between social goodwill and economic profit-maximization.

For instance profit-maximization objective leads to frequent downsizing and restructuring in corporations as they become large and powerful through mergers and acquisitions. Collective decisions (C) are now significantly changed by the change in ownership, control and management of the new giant corporation. Consequently, the \(P\)-variables lose their social meaning for the sake of economic interests. Economic efficiency, distributive equity, technological change, employment creation, market penetration, environment protection
and similar opposite couples, fall in the tradeoff caused by market competition and the drive of management and shareholders to maximize the net asset worth of a corporation.

In the end, the recursive feedback under the governing preference formation causes increasing marginalization of the social objectives for the sake of economic benefits for the corporations. The social policy variables lose their power while the economic ones enhance purely economic goals. Consequently, as economies today move into higher levels of privatization, market forces and globalization the process of social marginalization caused by corporations increases. The feedback earlier desired of $P$ is thereby ruptured between the social and economic sides.

**Islamic perspectives in corporate governance**

The groundwork of all forms of corporate governance is premised on the nature of preference formation caused by the internal dynamics of organization and interactive decision making within institutions, its relationship with the environing factors and lack of continuity of such a relationship. If the preference formation is premised on methodological individualism and recursive methods that breed on market forces, then the Arrow-Simon type of corporate behavior is perpetuated.

The preference behavior $\succeq$ is therefore premised on an epistemology carried by $\theta$-values to yield an episteme of action and response shown by $\succeq(\theta)$. $\succeq(\theta)$ is thereafter recursively regenerated by feedbacks between $(x,P)$-variables.

In the Islamic theory of corporate governance expression (2) acquires the form:

\[
W(\succeq(\theta)) = W(x, P)\succeq(\theta) \quad \text{(5)}
\]

\[
x_i(\succeq(\theta)) = f(x', P)|\succeq(\theta), \ i = 1, 2, 3, 4; j = 1, 2, 3 \quad \text{(6)}
\]

where $x_i(\succeq(\theta))$ denotes the $x_i(\succeq(\theta))$ variable without the $i$th one.

The induction of all the variables and functions by $\succeq(\theta)$ has a deep meaning. Such a transformation is not a mechanical one. The transformation means that since $x$ and $P$ vectors are both uniquely induced by $\succeq(\theta)$, they will have complementary relations between them rather than marginal substitution relationship of the neoclassical competition and scarcity based paradigm. Besides, the continuity of the feedback in the $x-P$ relations encompassing social and environing factors perpetuate such complementary relations. Because of the combination of the relations shown in expressions (5) and (6), interaction within and across organizations, markets and the organic environment lead to consensus formations that evolve in continuous cycles by their interactive, integrative (i.e. consensual) and evolutionary dynamics by learning (IIE-process). The background of the preference behavior establishes a continuous knowledge-inducing process model as opposed to a maximization model of corporate governance.

Yet the organic Interactive, Integrative and Evolutionary process (IIE-process) is not automatically established if the corporations are left to sheer market forces or to sheer competing social and environing forces and self-interest. The Islamic knowledge model of the most general type is premised on the epistemology of unity of knowledge as a relational order between systems. Between the Shari’ah-approved (i.e. according to the Islamic Law) possibilities of $(x, P)[\theta]$ the relational order is one of pervasive complementarities by systemic learning across diverse ways of interrelating the $(x, P)[\theta]$.

Thus, the organic characterization of reality is that all things interrelate in pairs (Qur’an 51:49) – ”And of everything We have created pairs, that you may remember (the Grace of Allah).” The pairing of the universe, which applies to both good things taken together and bad things taken together are separately paired bundles. The two categories mix only over a limited space of incomplete knowledge. But as the organic discourse towards attaining unity of knowledge proceeds, the indetermination problem is removed and is further evolved to greater certainty by truth recognizing the contrasting realities between truth and falsehood according to the Qur’anic law and the Sunnah. These two sources form the Islamic socio-scientific epistemological foundation and are combined with participatory discourse
among organizational entities of both institutional and every other relational domain. The latter comprises markets, society, science and environing factors. The formalism of the relational world-order is derived from the Islamic episteme of unity of knowledge.

The perspective of universal “pairing” as the sure sign of complementary relations among diverse entities discovered by the IIE-process referred to above, is the derived meaning of unity of knowledge. It springs from the fundamental epistemology of Tawhid (oneness of God = unity of knowledge) and relates to all issues of life in perpetually circular causation and continuity interrelationships. This yields what is known as relational epistemology.

$\theta$ is thus epistemologically determined in a general-systems configuration by the pervasively knowledge-inducing behavior of preference formation and its dynamic evolution across unifying fields of interrelationships (thus circular causation). The $x$-vector that is induced by $\theta$ signifies the capacity and transformation of the market, institutional and socio-scientific orders to embrace the true reality of the episteme of unity of knowledge. The $P$-vector likewise is the set of policies, strategies and instruments that continuously simulate the realization of systemic unity of knowledge in the IIE-process-oriented domains.

The medium of discourse through which the human mind interrelates to participate in the real issues with the goal of reaching a relational unification, is called the Shura (consultative participation). The Shura refers to the total organic process and medium of discovering unity of knowledge through systemic interrelationships (organic relational epistemology).

Thus the IIE-process emanates from the combination of four specific stages in the knowledge formation of the circular causation model of unified reality (Choudhury, 1995). These stages are namely:

1. The epistemology of divine oneness.
2. The primal derivation of unity of knowledge from this fundamental epistemology and is then codified in the light of the Shari’ah (Islamic Law). The result is the primal formation of $(\theta)$. 
3. The discursive medium of the $(x,P)[\Rightarrow(\theta)]$ systemic interaction and integration results in the simulation of $W(x, P)[\Rightarrow(\theta)]$. 
4. The organic evolution and continuity of the derived system is given by a system of unifying relations by means of the relational epistemology governing all variables and their relations by means of $(\theta)$. Such a system is shown by expressions (5) and (6).

The above-mentioned stages characterize the entire IIE-process and they proceed in circular causation and continuity across complex systems of relations and their defining variables.

**Applying the interactive, integrative and evolutionary process of unity of knowledge to the theory of corporate governance in Islamic perspective**

The very first perspective of Islamic methodology in socio-scientific systems, namely the Shuratic process (equivalently IIE-process) as derived by the Shura participatory relations institutionally and organically forms the most profound institutional and organizational model of governance in general and corporate governance in particular. Since the Shuratic process forms the totality of the sequences mentioned above, therefore, the complete functioning of Islamic governance is derived from the totality of the Islamic episteme.

According to Foucault (see Dreyfus and Rabinow, 1983, p. 18, see also, Foucault, *The Archeology of the Human Sciences*, University of Chicago Press, pp. 44-78) the concept of episteme is defined as follows:

By episteme, we mean . . . the total set of relations that unite, at a given period, the discursive practices that give rise to epistemological figures, science, and possibly formalized systems . . . The episteme is not a form of knowledge (connaissance) or type of rationality which, crossing the boundaries of the most varied sciences, manifests the sovereign unity of a subject, a spirit, or a period: it is the totality of relations that can be discovered, for a given period, between the sciences when one analyses them at the level of discursive regularities.
Since the preference behavior $\succeq (\theta)$ is the most important governing part of the epistemology, which is followed by the system comprised in (5) and (6), we must understand what is the role of the social wellbeing criterion function $W(x, P|\succeq (\theta) |$ in corporate governance.

Since the IIE-process is aimed at attaining greater degrees of unity of systemic knowledge according to the episteme mentioned above, therefore, the social wellbeing function becomes the criterion of corporate governance in evaluating the degree to which unity of systemic knowledge has been attained. Such a unity of knowledge is firstly evaluated internally in the corporation by observing an ordinal level attained by the degree of consensus formed by participatory process resulting in the determination of $(\succeq (\theta))$. Secondly, the social wellbeing function is used to evaluate the degree to which unifying relationships have been established between the $x$ and $P$ variables through the relational learning between the corporation and its enviroring factors. The social wellbeing objective criterion is thus subject to actions and responses in the IIE-processes.

**Principles and instruments governing Islamic social and economic conduct**

In the enviroring domain governance is imparted by the knowledge induction of the menus of production, consumption and distribution of resources, income and wealth that reflect the following four key principles (Choudhury, 1989):

1. Extension of the episteme of unity of knowledge through the IIE-process to the interacting envoirning factors. This unfolds the complexity, richness and diversity of the unifying process of learning systems that are embedded in world-systems.

2. The principle of justice as balance and fairness.

3. The principle of productive engagement of resources in social and economic activities.

4. The principle of recursive interaction between the above stages to form intra- and inter-systemic complementarities as the “pairing” feature of unity of divine knowledge exemplified in systemic interrelationships (circular causation and continuity of relations).

These principles are true of organizations and institutions in an economy that evolve toward an Islamic political economy from their initial imperfect standards.

The $P$-vector becomes centrally important in generating the recursive IIE-process feedback intra- and inter-governance systems. To bring about the kind of unity of systemic knowledge as explained above, appropriate kinds of instruments used are:

- Preference formation toward avoidance of waste in consumption, production and distribution of all kinds of resources. This leads not only to intertemporal ecological consciousness but also determines the kinds of goods and the technology that would be determined by the resulting ecologically conscious development regimes.

- One kind of social waste is considered to be the rate of interest (all kinds of term structures, real and nominal) as the cost of unused capital existing in the form of liquid savings. The Shuratic preference formation by discourse between a corporation and the Islamic political economy phases out interest rate regimes and causes spending to arise by resource mobilization rather than savings, meant here in the sense of withdrawal of employable resources.

- Interest rate as a “bad” is replaced during progressive Islamic transformation by co-operative instruments. These are fundamentally of two types – Mudarabah (profit-sharing under economic co-operation) and Musharakah (equity participation). Around these principal instruments other forms of financing and development co-operation instruments revolve, such as Murabaha (cost-plus pricing), foreign trade, rental, secondary instruments of unit trusts and financing indexes. Such co-operative instruments generate and survive on extensive participation in and between the economy and society. The progressive reduction of interest rate and its replacement by the co-operative financing and development instruments enhances the evolving organic
participation at all levels. This causes productivity as well as equitable distribution of entitlement and formation of empowerment in society at large.

- There is the social obligation of the corporation to pay wealth and resource tax on its retained earnings. This tax is known as Zakat and equals 2.5 per cent of idle wealth and assets annually. The volume of Zakat has a positive functional relationship with the transformation process toward a participatory economy with progressive reduction of interest rates. The limits of Zakat as with Mudarabah and Musharakah and likewise the phasing out of interest rates transcend national boundaries into international resource flows across the Muslim World.

Waste is reduced; participation is extended by way of co-operation; and social and distributive justice, balance, equity, equality and social security are progressively enhanced in the Islamic political economy between the corporation and the environing factors. It is now logical to deduce that the kinds of development regimes that corporations work in and promote within the goal of Islamic transformation are those of dynamic (i.e. evolving) life-fulfilling needs. The technological change in this milieu of development too is of a similar type, appropriate and cost effective. The extension of participation, thereby risk-sharing, product diversification and technological appropriateness and the causality with the development regimes of dynamic life fulfilling needs causes the cost effectiveness and social appropriateness of such transformation. The corporations play a vital role in this transformation process by causality between itself and the environing factors.

We have now interconnected the unification process of knowledge derived from the Islamic episteme and its functional realization through the Shari’ah. The \((x, P) \Rightarrow (\theta)\) vectors and the continuous recursive actions and responses between them in and through \(W(x, P) \Rightarrow (\theta)\) along the IIE-processes is secured through the discursive processes within the corporation and between itself and the environing factors.

**Corporate governance in a dual Islamic economy**

The dual Islamic economy is an embedded one within the prevalent mainstream economic system in which, economic competition, methodological individualism, moral hazard, information blockage and irresponsible behavior are rampant. What is the nature of Islamic corporate governance in such a case?

The answer is given by a segmented-market approach. The Islamic organizations, markets, products, menus and strategies are promoted in specific markets and trade within national boundaries and internationally. Islamic banks undertake this task currently by entering into Islamic financing instruments for their specific clientele and selecting markets where interest rates are avoided by shareholding in Shari’ah-recommended outlets. The expansion of the Islamic corporations like Islamic banks and Islamic Insurance companies in segmented markets embedded in mainstream economies needs the power of the behavioral transformation of preferences in increasing awareness and practice of the participatory practices, as mentioned earlier for the IIE-process. This program requires extensive human resource development and knowledge induction at the community, national and international levels.

The hostile environment of competition by mainstream corporations and the impossibility of Islamic corporations to enter into strategic alliances in such other portfolios might first appear to limit the expansion of Islamic economic and financial activity. This is not a proven fact though. In Malaysia during the heydays of the economic and financial crisis the Islamic financial portfolios remained stable. Currently, while commercial bank interest rates remain low and the stock markets are showing high volatility, Islamic banks and investment companies are offering stable after-tax rates of return of approximately 7 per cent. This is a global picture with most Islamic banks. Hence linkages across Islamic financial institutions are made possible in such a climate of financial stability and the prospect of gaining in total productive possibility by linking financial and money resources with the real economy.

Table I gives the profitability of Islamic banks in a dual Islamic economic case. The interesting point to note is the higher yield on equities (ROE) than on assets (ROA). This
indicates the efficacy of Islamic financial institutions in resource mobilization as opposed to fixed asset formation.

With the growth of Islamic financial and economic institutions, even within segmented markets, it will become increasingly attractive to gain national support to promote the operations of such institutions. The automatic prevalence of transparency, business disclosure, absence of predatory competition and anti-trust consequences coupled with sustainable productive performance with social benefits will enhance trust. A national policy to recognize the special nature of Islamic corporations and financial institutions is absolutely necessary. While Islamic banking has been given a special status within Bank Indonesia, in Sudan and Iran, this is still lacking in other Muslim countries.

The issues of imperfect development along lines of the Islamic epistemological premise in a dual Islamic economy nonetheless points to a dynamic potential for establishing Islamic institutions that learn themselves into better states of development by internal and societal governance practices. The important resulting picture is that of potential linkages according to the terminology of perpetual learning by systemic complementarities that Islamic institutions can continuously generate by the IIE-process methodology of governance within the environing world-system. The aspiration through such an experience is that of transforming the Muslim social, political and economic orders into more Islamized states. Yet in all these developments no claim of perfect transformation is made according to the IIE-process methodology. Consequently, what we derive from the dual Islamic framework of learning in corporate governance is an example of the theory of evolutionary institutionalism (Jackson, 1993).

The Islamic perspective of corporate mutuality

The mainstream approaches to corporate governance are substantively altered in the Islamic case. The Rationality episteme is opposed and is replaced by the episteme of Unity of Divine Knowledge understood now in terms of its functional perspective working through the Shari’ah-determined instruments. This premise is used to develop guiding rules of participation and sharing in the cost, profit and risk of joint ventures. Participation across inter-systems and intra-system being the ultimate structure of the Mudarabah-Musharakah (profit and equity participation) and similar co-operative ventures, the shareholders become active participants in the decision-making process as stakeholders.

Now the ultimate objective criterion of the Shari’ah Board and the constituent Shuras of groups of participants is to simulate the social wellbeing function for common wellbeing

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<td>19.2</td>
<td>11.3</td>
</tr>
<tr>
<td>QIB</td>
<td>0.4</td>
<td>1.1</td>
<td>-2.3</td>
<td>16.4</td>
</tr>
<tr>
<td>IBBL</td>
<td>1.4</td>
<td>1.4</td>
<td>32.9</td>
<td>28.8</td>
</tr>
<tr>
<td>BIMB</td>
<td>1.1</td>
<td>0.9</td>
<td>13.2</td>
<td>13.2</td>
</tr>
<tr>
<td>Simple</td>
<td>0.78</td>
<td>1.19</td>
<td>10.71</td>
<td>14.13</td>
</tr>
</tbody>
</table>

Notes: BIBB: Al-Baraka Investment Bank of Bahrain; BIB: Bahrain Islamic Bank; FIBB: Faysal Islamic Bank of Bahrain; IBBL: Islamic Bank of Bangladesh Ltd. DIB: Dubai Islamic Bank; FIBE: Faysal Islamic Bank of Egypt; JIB: Jordan Islamic Bank; KFH: Kuwait Finance House; BIMB: Bank Islam Malaysia Berhad; QIB: Qatar Islamic Bank

Source: Rahman (2001, pp. 51-74)
rather than to only maximize shareholders’ wealth. This is not a mere altruistic goal. It is
rather than to only maximize shareholders’ wealth. This is not a mere altruistic goal. It is
driven by the logic of mutual interest. In this way, the social goal becomes strongly
driven by the logic of mutual interest. In this way, the social goal becomes strongly
complemented with the private goal, reflecting thereby the working of the principle of
complemented with the private goal, reflecting thereby the working of the principle of
complementarities between the diverse \((x, P, \theta)\) variables and their relations. The circular
complementarities between the diverse \((x, P, \theta)\) variables and their relations. The circular
feedback causation interrelationship regenerated in the IIE-process becomes a strong case
feedback causation interrelationship regenerated in the IIE-process becomes a strong case
of corporate mutuality. In this way much of the institutional transaction costs caused by lack
of corporate mutuality. In this way much of the institutional transaction costs caused by lack
of transparency, moral hazard and excludability are reduced in the presence of active and
transparency, moral hazard and excludability are reduced in the presence of active and
responsible participation at large.
responsible participation at large.
The contrast between the mainstream and Islamic features of corporate governance is
exemplified in Figure 1. The important point to note in Figure 1 is that human resource
development, preference formation and consequent management of the entire organization
development, preference formation and consequent management of the entire organization
undertaken by the board, management, employees and shareholders in mainstream
undertaken by the board, management, employees and shareholders in mainstream
corporate governance perspectives are driven by the objective criterion of competition and
corporate governance perspectives are driven by the objective criterion of competition and
conflict in the shareholder wealth maximization objective (Lazonic and O’Sullivan, 2000).
conflict in the shareholder wealth maximization objective (Lazonic and O’Sullivan, 2000).
Consequently, the market forces are self-organized according to this kind of preferences
Consequently, the market forces are self-organized according to this kind of preferences
and organizational preference behavior. Yet markets are not benign domains of exchange.
and organizational preference behavior. Yet markets are not benign domains of exchange.
Rather, they represent exchanges of social contracts that are developed within institutions
Rather, they represent exchanges of social contracts that are developed within institutions

Figure 1 Comparative views of corporate governance: Islam and the other perspective

Non-Islamic Perspective
Rationalism and Rationality as the Episteme

| Pressure Groups |
| Shareholders |
| Regulatory Authority |
| Non-Management Agents: Customers, Suppliers, distributors etc. |

Islamic Perspective
Tawhid as the Episteme

| Shari’ah Board: Ultimate Governance |
| Shura: general Representation Also |
| general shareholders’ representation plus community participation |
| minimal Regulatory authority except reproduction of knowledge and control |
| Social Wellbeing: testing for Unity of knowledge according to the Shari’ah: strong complementarities between private and social interests |
| followed by evolution: Shuratic process |
and carried through all organisms including markets by the preferences of the agents involved in institutional decision making.

Circular feedback of the IIE-type does not exist in the mainstream case due to conflict (Figure 1) between social and shareholders wealth maximization objectives. Consequently, the conscious shareholders or the community as groups is marginalized in respect to social preferences. Shareholders fail to become effective stakeholders to play a socially active role in terms of deciding over the social appropriateness of shareholders’ wealth, as in the case of the principal-agent methodology of corporate governance.

In the case of Islamic corporate governance the conflict is overcome by the organic participatory nature of the Shuratic process both as a discursive body as well as a learning medium with factors of the world-systems. The social wellbeing criterion replaces the criterion of maximization of shareholders wealth. Hence systemic unity is sought both between the corporations and the shareholders and the social and economic factors. This is the logical consequence of the epistemology of unity of knowledge governing over systemic relations under pervasive complementarities as opposed to marginalist tradeoffs of the neoclassical genre in mainstream corporate decision making.

Conclusion: conceptual results

We can now conclude this paper by answers to the following two questions: what is an Islamic corporation? How is it governed for operational effectiveness, accountability to shareholders and social responsibility?

An Islamic corporation is a legal entity of shareholders with principal and proportionate ownership of assets according to individual group equity and profit-sharing capabilities. Mudarabah and Musharakah contracts and other ones that revolve around these principal development-financing instruments establish the legal validity of the corporation. Absolute ownership within an Islamic corporation is thus replaced by proportionate ownership according to participation and in view of the extensive co-operative linkages established.

The Islamic corporation has a prime role in Islamization. Thereby, matters of participatory enterprise across the economy and shareholding nationally and internationally according to Shari’ah rules, become mandatory on the Islamic corporation. The built-in openness and transparent nature of the Islamic corporation in its business dealings with members and shareholders increases effectiveness in product and risk diversification and in developing segmented markets of Islamic products. The driving force of complementary relations between economic efficiency, economic growth, technological change, capital, labor, social justice, equality, sustainability, stabilization and productive transformation by mobilizing financial resources into the real economy according to Shari’ah rules, makes the Islamic corporation market driven within a social and responsible co-operative milieu. Above all, the continuous knowledge-driven Shuratic process (IIE-process) of discourse, search, discovery and expansion of complementary possibilities forms the systemic application of the epistemology of unity of knowledge in the case of corporate governance in Islamic perspectives.

With the ethical market-driven nature of the Islamic corporation, external governance of such an organization becomes increasingly redundant in a progressively Islamizing political economy. The most critical governance of the Islamic corporation is by its guidance toward the formation of behavioral preferences premised on the systemically organic meaning of unity of knowledge by pervasively relational complementarities and linkages. The human resource development effects are grounded on such a perspective of unifying interrelationships between the Islamic corporation and its internal and external environing factors, using the cogent set of Shari’ah instruments that enable the complementary relations to be established and perpetuated.

References


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