



## A INTRODUCTION TO TRANSACTION COST IN ECONOMICS (EMPHASIS ON PRINCIPLES OF CONTRACT IN ISLAM)

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### ABSTRACT

In the 1950s and 1960s, the neoclassical theory of the firm was criticized for its unrealistic assumption and the assumption of zero transaction costs, was questioned. According to the North perceptions of Coase theorem about transaction costs, although in neoclassical imaginary world that is based on "transaction costs are equal to zero" assumption, market mechanisms can create efficiency without institutional arrangements that define the rules of the game but in the real world that transaction costs is positive, institutions (legal rules) have effect on the allocation of resources. Thus, the Coase theorem clarifies the relationship between transaction costs and legal norms. Transaction costs are costs that parties paid for information gathering, or non-performance of contract by the other party, or to be incurred for monitoring and enforcement of contracts. Because contracts are incomplete that means the mutual rights and obligations of the parties have not been agreement in many cases and therefore it is not mentioned explicitly in the contract so not to mention the rights and obligations means there is a gap in the contract thus one of the main functions of a legal system about contract law would do to fill this gap by defining the supposed rules. By definition, the assumed rules are including rules that determinate mutual rights and obligations of parties for possible states that usually are not defines in contracts. Therefore, with considering to conditions for contract can be improved somewhat flaw in the contract.

Terms and provisions of the contract in Islam, and investigate of the moral and religious principles governing on Islamic contracts, show that there are teachings that can greatly due to transaction costs reduction, efficiency increase and satisfaction of parties in contracts.

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### INTRODUCTION

The theories of economic growth were focused on mechanical systems of theoretical economy in twentieth century and they were often assumed as minor factors in analyses and institutions. But accumulation of physical capital, integration of human capital, and technological changes may explain only some part of economic growth over the time. Further complex factors have explained the economic growth during two and half centuries ago. The failure of prevalent economic models and collapse of former Soviet Union encouraged many economists like North, Coase, and Williamson to interpret economic performance with a traditional perspective. These economists focused their attention on institutions as rules of economic games instead of physical factors (Karden, 2012) and institutional economy was gradually converted into one of important economic schools. Simultaneously with decline of classic institutional economy within two World Wars neo-institutional economics was gradually

formed. Transaction Cost was one of the foremost subjects, which have been noticed in neo-institutional economics but it should be considered that as neo-institutional economics is not an integrated totality and it includes various attitudes and approaches so there is no single approach about subject of transaction cost. (Motavaseli and et. Al, 2010)

Today, pursuant to Ronald Coase, the economists define transaction cost proportional to several phases of any contract and they assume transaction costs including the related expenditures to several stages of contract like procurement costs, bargaining costs, and costs of contract conclusion. In other words, from this perspective, the transaction cost may be divided into three categories

1. The costs for finding location and attraction of potential trading parties
2. The costs of concluding and execution of contract; and

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3. The costs of supervision and enforcement of contract. (Cooter and Ulen, 2000; klaes, 2009)

It is assumed in economy of transaction cost that the agents act rationally in terms of methodology. Of course, their rationality is limited and they have no access to all needed information for concluding contract and accrual for transactions and also if this facility exists they could not process such data and they have to inevitably conclude the partial contracts. As a result, it is potentially possible the existing deficiencies in contract to be abused by opportunist people and to break the contract and consequently to impose some costs to transaction parties (transaction cost). In this attitude, it is supposed that the rational people are aware of the possibility for breaking of contracts (cost consuming transaction). Hence, they should think about some strategies to achieve their goals before conclusion of contracts in order to incur the lowest cost after conclusion of the contract. (Nasiri aghdam, 2006)

Partial nature of contract means that mutual rights and obligations of both parties have not been agreed in many possible cases and consequently they have not been explicitly mentioned in the contract. Not embedding of this group of rights and obligations expresses the existing gap in the contract. Filling these gaps by definition of the assumed rules is one of the paramount performances, which are done by rule of contracts in a legal system. By definition, the assumed rules includes some regulations, which determine the mutual rights and obligations of both contract parties in the possible conditions may not usually implied in the contracts. (Craswel, 2000)

Cooter and Ulen have divided the existing deficiencies of the contracts into two general classes. According to their view, the first class of such deficiencies, which may occur in contracts, refers to irrational behavior. Such behaviors are done usually by the persons, who cannot behave rationally because of various reasons like minority of age and or insanity. The second class of these deficiencies, which may emerge in a contract, is related to higher transaction costs. The major group of such deficiencies may be referred to lack or dissymmetry of information among both contract parties. (Cooter and Ulen, 2000)

The review of Islamic texts indicates that there some essential guidelines about agreements and conclusion of contracts in Islam where these teachings have been interpreted within contract rights and regulations and some other ethical teachings and they may reduce effectively transaction cost to great extent. For example, maturity, wisdom, free will etc are some conditions, which either of contract parties should possess for the sake of authenticity of contract. Moreover, one can refer to several cases about these issues among jurisprudential and legal regulations such as forbidding of misrepresentation and dissimulation of transactions and generally any type of fraud and deception that may lead to loss for the opposite party and also avoidance from deliberative objection of disclosure of information, which are supposed by rational parties as playing role in that transaction and prevention from presentation of improper information (Rajayi, 2012) etc that the information about reduction of transactions cost and removal of information deficiencies. In addition, according to Islamic legal teachings if conclusion of a

contract is in such a way that leads to unfair redistribution of wealth in favor of either of contract parties the opposite side is allowed to use option of rights in the given contract for revocation of contract unilaterally. (shahid aval, 1990) Overall, a major part of what is identified as Options in Islamic jurisprudence is closely related to the existing information deficiencies in the contracts. (sharifzade and naderan, 2013)

Along with these issues, the governing principles over the market climate and Islamic contracts leads to emerging of ethical virtues such as prevention from telling lies, avoidance from oppression and extortion, not prevailing personal interest-seeking, creation of honesty, benevolence and fulfilment of promises, observance of equity and fairness etc in market so that we interpret these principles and their role in reduction of transaction cost in Islamic transactions in this essay.

### **Literature & Theoretical**

Transaction Cost Economics (TCE) has a long history since term of transaction cost has been used in economic literature for several centuries. Theory of (economic) friction is one of the deep impacts, which have created the recent developments. In this theory, market is similar to a machine in which friction may divert its performance from ideal state. For many years, the concept of transaction cost was supposed only as cost of transportation until nineteenth century when Manger interpreted the meaning of friction in his book. By doing it he intended to explain the existing differences in the related models. Thus, TCE has long history but it has short background as a science. For the first time in 1979 decade, in his essay, Williamson has referred to economic term of "transaction cost"

When phrase of "transaction cost" appeared in economic literature, theory of "Transaction Cost Economics" entered into economics

"Transaction cost economic: the governance of contractual relations".

### **Concept of transaction cost**

Neo-institutional economics started to form with writing an essay titled "Nature of enterprise" by Ronald Coase in 1937. (Coase, 1998) In article of nature of enterprise, Coase tries to correct it by taking a critical outlook toward neoclassic economy. He writes: this paper is intended to fill the existing gap in economic theory apparently among two hypotheses where one of these hypotheses is that price mechanism tools are responsible for allocation of resources and the latter assumption denotes that coordinating entrepreneur allocates the resources. (Coase, 1973)

Looking at Coase's essay more accurately indicates that in that paper, he did not use term transaction cost but the subject that was purposed by him in that article became as a basis to formation of extensive subject of transaction cost. According to Coase's view, whereas the given essay caused addressing the subject of transaction cost in economics, the starting point of neo-institutional economy is introduced. (Coase, 1998)

But the second effort was started for amendment of neoclassic theory from different path: To analyze economic behaviour, Hayek noticed human and define

several phenomena in his mind and focused his emphasis on mind by publishing book of "Sensory order: An inquiry into foundations of theoretical psychology" in 1952. In this book, Hayek explores the mind performance based on connectionist model. (Arena and Festre, 2006) Similarly, Simon interpreted subject of limited rationality. At the last year of his life, Simon writes in an illustration about limited rationality that: "The limited rationality briefly denotes that election of individuals is not determined only by some of compatible general goals and features of external world, but some other factors are important as well including the knowledge that they have or have not about the world, their capability or incapability in acquiring knowledge at appropriate time, management the results of their actions, addressing the possible action routes, managing of uncertainty and judgment about most of their competitive requests. The rationality is limited since their potentials are extremely restricted. As a result the rational behaviour in real world is mainly determined by internal context of individuals' mind including contents of memory and its processes and external environment as the world in which they act and operate on them. (Simon, 2000)

The purposed topics by Coase, Hayek, and Simon are not only the important factor in formation of neo-institutional economics, but also they cause at least emerging two different streams in neo-institutional economics where theorists interpret these two streams as different analyses on the same phenomena. In discussion about transaction cost, this difference in analysis can be seen well. In this topic, Williamson has followed up Coase's issues and North has used the topics of Hayek and Simon as the basis for his work as a result they look at subject of transaction cost from different point of view as well. (Motavaseli and et. Al, 2010)

#### **Transaction cost according to Williamson's view**

Williamson posits behavioural theories to justify cost-consuming nature of transactions theoretically. Based on his opinion, commitment to perfect or instrumental rationality is the main reason for failure of the current theory for recognition of transaction cost since if theory of exiting perfect rationality is assumed therefore no partial (deficient) contract is not concluded while their partial nature is the main feature in real contracts. Pursuant to Simon, he acknowledges the assumption of limited rationality as one of the theoretical bases in transaction cost economics. The limited rationality means that economic factors behave rationally but there are some restraints in this course.

One of these limitations is lack of access to the existing information and knowledge and the other restriction is incapability of human's mind in perfect data processing. These restraints may cause rational human not to be able to conclude the needed contracts for doing transactions in perfect and intact and sound form. As a result, the first principle in transaction cost economics is that contracts are always incomplete and partial. By accepting this principle, this question may be raised that if it is not possible in the case of occurrence some changes, either of contract parties to abuse its incomplete nature for his/ her own interest and other cost due to incomplete nature of contracts.

Williamson gives positive answer to this question and this positive answer may lead him in accepting the second hypothesis about behaviour of transaction cost economics i.e. opportunism. Namely, on many occasions the individuals may follow up their interests by fraud and deception if they can. If this assumption of opportunism is composed to principle of contracts partial nature then the possibility for breaking of contracts and contractual risks will be increased. If a contract is violated this means that contract parties should also pay some costs for conducting transaction: The transactions are cost-consuming and as contracts are violated further, the transaction costs are higher as well. As a result, cost-consuming nature of transactions is justified and formulated within theoretical framework. When we acknowledge that any contract is partial and incomplete and time-consuming in composition with opportunism in fact we have accepted this point that any other alternative method for doing a single task (where each of them corresponds to a contract) is cost-consuming. Therefore, after theoretical accepting of cost-consuming nature of transaction, Williamson follows up this objective that transaction should be organized by various organizing techniques to economize or minimize transaction costs. (Williamson, 1998)

Consequently, Williamson achieves to his second principle and states: reducing the risks caused by opportunism, which subjected to retrospection, is considered as the axis for activity of transaction cost economics by selection of prospective organizing technique. In other words, at any moment of time, due to possible opportunism of individuals, some costs may be imposed to the organization where these costs are caused by the existing deficiencies in design of organizations in the past (upon conclusion of contract). Thus, it is tried in design of an organization to take some mechanism for systematization of activities in order to create the lowest cost for organization in the future (after conclusion of contract). This idea is the business pivot for transaction cost economics. (Nasiri aghdam, 2006)

#### **Transaction cost from North's view**

In most of his essays, North starts his discussion with criticizing the neoclassical theories.

With critique over ignoring it in neoclassic economics regarding transaction cost, he highlights this cost covers approximately 50% of Gross National product (GNP) in the advanced western countries. (North, 1991)

In one of his early works, North defines transaction cost as follow "Transaction cost is the cost of assertion and execution of contracts, which are the basis for agreement." Based on his view, four main variables are determinant in transaction cost including 1) Measurement cost where measurement comprises of goods valuable features, the transacted services or measurement of agents' performances; 2) Nature of transaction process that includes accurately determination of contract terms and guarantee for its implementation; 3) Execution and way of guaranteed execution in which it means in fact the existing rules and courts; and 4) Ideological attitudes. According to North's view, the fourth variable differs from other variables. Unlike neoclassic assumptions, preferences and

tastes are not fixed; hence, this variable cannot be constant as well and it is related to moral values. (North, 1984)

North discusses about fourth cost in more details and he writes in this regard: "The ideological power may be measured by the extra fund that individuals like to pay for exploitation from hitchhiking for free." This extra cost is the cost of idea that is not only proportional to individual's beliefs regarding fairness of transactional rules and regulations, but it is affected by education, promotion, and symbols. North divided these factors into two classes of measurement and execution costs several years later. North employs these variables for distribution of types of economic organizations and structure of community. This North's full explanation about reasons for emerging transaction cost stems from his critique to Coase and his followers. Based on his opinion, Coase and many of those ones who have explored transactional costs, have not tried to identify accurately what it makes higher cost for contract conclusion. (North, 1990)

North argues that transaction zero cost never be realized since the condition for its realization is that the actors not only have to possess certain goals, but they should be aware of proper technique to achieve it and it is a fact which does not take place in real world since unlike theory of instrumental rationality, the persons act based on partial information and subjective models and information feedback is also not adequate for correction of these partial subjective models. (North, 1994) With reliance on Simon's remarks about the existing partial rationality and instability of values, North emphasizes on role of institutions in economic transactions and processes. (North, 2000) In this regard, he writes that institutions put a structure for transaction at our disposal (that is employed along with know-how) that determines transaction and conversion costs. Incentive of actors (function of their utility), complexity of context, and capability of actors in deciphering and organizing the environment (measurement and execution) are determinant the rate of success for institutions in coordination and production. The institutions which their existence is necessary for economic transaction may differ in terms of complexity order. (North, 1990)

On the other hand, North follows up the subject about institutions with respect to transaction cost as well. He writes in this sense that may theory about institutions is a combination of theory about human's behaviour and contractual costs so if we integrate these two theories to each other it is possible to perceive why these institutions exist and what role they may play in performance of communities. Apparently, addressing the historical changes and thus transaction cost by North might affect importantly on his analyses.

**Types of transaction cost**

According to Simon's view, two characteristics are essentially important, which one of them is related to humans' capability for perception and the other is the utility and favourable nature for them. He purposes concept of limited rationality regarding the first case. The limited rationality means that human behaves rationally but due to wide range of information and their partial nature, s/he cannot behave fully rational. In other words,

human's mind may not process a mass of information and for this reason it is limited in following of rational behaviour. Concerning to second case, he presents weakness of incentives and their vulnerability.

Transaction cost economics acknowledges theory of limited rationality. This is essentially important for economic organization in that all contracts are complex and inevitably partial. Transaction cost economics is concerned with utilitarianism (benefit-seeking) as well, not as weakness of incentives, but as opportunism. Opportunism may impose further complexities to contracts. The contracts not only are incomplete usually due to the existing limited rationality and there are some errors, gaps, and omissions, but also due to opportunism simply a commitment, which has not been guaranteed by reliable commitments, will not be executed. As we implied, transaction cost includes those group of costs, which are incurred by individuals in process of economic transaction in order to identify, define, and guarantee right of their ownership. In other words, if we suppose assumption of transferring ownership rights as a basis then in transaction costs some costs may overshadow to transaction like costs of acquiring information about vendor, buyer, quality of goods and services, cost of contract conclusion, costs for supervision, control, and legal enforcement of contracts and most importantly the costs regarding definition of rights of ownership and guarantee for enforcement of these rights and thereby they create platform to form transaction cost. (Nasiri aghdam, 2006)

Thus, transaction costs include the following items

- The cost of acquiring information about vendor, buyer, and quality of goods and services;
- Costs of concluding contract;
- Costs for supervision, control, and legal enforcement of contracts; and
- The costs regarding definition of ownership rights and guarantee for enforcement of rights for transaction

**Islamic ethical teachings**

There are some principles and rules which govern over Islamic market that result in creation and flourishing the behaviours, which lead to reduction of information defects and transaction costs in Islamic contracts. In this section, some of the paramount principles and governing rules over the climate of transaction in Islam and the originated behaviours from these principles are explored.

**Table 1** The governing principles over Islamic market

The governing principles and rules	The behaviours originated from these principles
Governing the god's remembrance and some attitudes like human as God's caliph and supposing this world as a farming field for resurrection day	Lack of predominance of personal utilitarianism
Human's dignity	Avoidance from oppression and extortion in rights of buyer and vendor and prevention from fraud and deception, prohibition from intervention in others' contract, and omission of unnecessary brokers
Justice governance	Acquisition of fair and equitable profit, rejection from utilitarianism
Value of work and utility of business	Avoidance from laziness and lethargy

Requisite for abidance by commitments	The necessity for fulfillment of promises
Benevolence and generosity and equity	Not receiving profit (interest) from someone to him/ her the vendor has promised to give profit, equity with others, lack of loss for others
Lack of opposition to moral values	Misrepresentation, usury, dissimulation, presentation of false data, deliberative objection from disclosure of information for which they rationally attached role in transaction

### Honesty in contracts and agreements

Honesty is one of the characteristics on which it has been highly emphasized in Holy Quran. Honesty means its wide concept i.e. honesty in intention, behaviour, and structure. Trusting, fulfilment of promises, equity, and what is led to confidence and trust among both transactional parties in speech or in practice and included in this area. Honesty is manifested in individual relationship with his/ her own, god, and other members of community and with environment and it appears in the given individual or market as the penetrated characteristic and as a result it create balance among physical and internal faces, speech and writing, and expression of matrix and behaviour and all of these. In this market, both parties may feel sense of confidence from behaviour of each other and there is no hidden information deliberately regarding transaction or goods in the market and if any mistake is made, it is possible to compensate for the mistake in mechanism of market. (Davoodi et al, 2012)

Several Quranic verses have been mentioned about this subject so for example it is referred to some them

In Holy Quran, honesty has been implied as characteristics of pious people (Motaghin) and Almighty God has promised the honest people (Sadeghin) the paradise and He has ordained the believers to be accompanied with honest people (Innocents).

In other narrations, honesty has been mentioned as characteristics of prophets and telling truth and fulfillment of promises have been considered as sign of divine faith. (Koleyni,1969) Imam Ali (PBUH) expresses: The best people are who tell the truth under all circumstances and one, who accompanies with truth, will be rescued. (Majlesi, 1983)

Telling lies, fraudulence, and treason are against honesty. In Islam, it is forbidden to tell lies and to commit fraud and treason. There are a lot of Quranic verses and narratives, which refer to this issue so we avoid from their implication because of clear nature of this subject. (Majlesi, 1983; Koleyni,1969)

Honesty and avoidance from telling lies and fraud and treason are very important in contracts and treaties. Hence, Imam Ali (PBUH) recommended merchants and marketers to avoid from telling lies (Horeameli, 1992) and also Imam Sadegh told to one of his companions, who intended to take trip for merchandise that

“Tell the truth! Do not hide defect of your commodity and do not deceive someone who trusted in you and so forth. And do not commit treason since honest and truth-telling merchant will be accompanied and resurrected with divine high-ranking and benevolent messengers in resurrection day”. (Horeameli, 1992)

Rather than forbidding nature of telling lies, the lies and fraudulence may cause revocation of contract for the opposite side as well. For instance, if someone sells his/ her merchandise higher than the price of its market value or imply unreal features about his/ her goods or delivers defective commodity while hides its defect, either transactional party is entitled to revoke the contract. (Mir-moezi, 2007)

## DISCUSSION & CONCLUSIONS

As it shown in the table, governance of the above principles in Islam may cause emerging some behaviours like avoidance from fraud and fraudulence and abuse from information, the necessity for fulfilment of promises etc and all these behaviours may play essential role in lowering transaction cost by transparency of information and creation of honesty and appropriately guarantee for contracts due to the existing strong commitments and the like. In this part, we explain about some of the foremost governing principles and rules over contract briefly.

### Knowledge about the features of contract object and contract

Both contract parties should be fully aware of the features of contract object as well as contract and they should know the amount, kind, specifications, and price of contract. (Moosavi khomeyni, 1995) Otherwise, contract will be null or void. This rule makes it necessary for both contract parties to give accurate and proper information to each other.

### Requisite for fulfilment of promise, contract, and the terms of contract

Almighty God in many verses of Holy Quran has ordered the human to fulfil their promises: (Maedah Sura: (5:1) “Oh Believers! Fulfil the promises ...” (Asra Sura (17:34)) “...and fulfil the promise; surely (every) promise shall be questioned about.” God mentions fulfilment of promises as the good deed and along with performance of prayer and payment of Zakat (Islamic tax) and at the same time Imam Ali (PBUH) declares solidarity and persistence in fulfilment of promises as one of characteristics of Islamic believer in his oration that he read for Hammam (his companion) while he implies fulfilment of promises as one of signs for the believers. (Noori tabarsi, 1987)

Similarly if either of contract parties considers any condition or term against their own s/he should be committed to it during contract period. This rule can be inferred from the following narrative:

“Muslims should fulfil their conditions unless the given condition is contradicted to content of God’ Holy Scripture. In such a case, it is not advisable to stipulate such a term.” (Horeameli, 1992)

There are many Islamic narrations in this regard. The requisite for fulfilment of promises and terms of contracts and their implicit commitments may create trust and confidence atmosphere throughout the market. (Mir-moezi, 2008)

### The consent and free will in contracts

This condition is the cornerstone for all contracts. In the following Quranic verse, this subject has been highlighted: (Women Sura (4:29): "O you who believe! Do not devour your property among yourselves falsely, except that it be trading by your mutual consent ...". Here reluctance in contract means someone threatens other person if s/he does not enter in his/ her contract the given person will damage his/her life, property or reputation and or his/ her spouse and children. (Moosavi khomeyni, 1995) Accordingly, if a contract or transaction is done with reluctance and or dissatisfaction either of parties that contract or transaction is invalid.

### CONCLUSION

Neo-institutional economics has explicitly concentrated its focus and notice on social institutions. Douglas North assumes institutions as the foremost determinant factor in economic performance. In North's definition (2005), institution includes formal rules and informal norms and their execution characteristics. Institutions determine structure of ownership rights and thus transaction cost.

North and Thomas define an institution as an agreement among economic units. Agreement between economic units or institutions may form a structure that cannot be easily violated. For example, several guilds may enact some regulations in markets also they are not legally binding, they may include highly sanction in such a way that their infringement will be exposed to reaction from others and lead to omission of the violator from that market in some cases. In another essay, North emphasizes that institutions include a group of behavioural commitment and clauses in form of rules and regulations as well as a system of moral behavioural norms; these norms determine the structures, which restrict how to identify and execute their rules and regulations. In addition, they are employed to change intrinsic incentives for market transactions such as personal interest. In recent studies on economic development, special attention was paid to religious beliefs and religion as the efficient institutions in the path of achieving economic development. North focuses on institutions since institutions are incentive structures, which organize people's behaviour and at last they determine economic success and failure. These incentive structures determine that economy will be subjected to recession. The institutions, which encourage people to competition in production and transaction, will be led to improvement in life standards for the people. The institutions, which develop incentives for dispossession and redistribution of resources, may explicitly exacerbate recession. Those communities, which include disappointing incentives for production, tend to become poorer over the time and the communities in which there are encouraging incentives for production, tend to become more affluent over this time.

The various attitudes of the people toward religion and especially that people who possess power for legislation will result in different evaluations concerning to what it should be included in content of formal rules. Thus, formal rules directly and clearly affect on economic performance. They comprise of should and should-not items, which are stipulated by the government. With respect to the aforesaid

issues in this article, we find that in Islam the group of rules and regulations on the one hand and ethical teachings on the other hand efficiently influence in people's behaviours and economic factors and they may increase business and effort and prosperity of production, on the one hand, with moral training and creation of appropriate incentive by assuming work and effort as valuable and through prohibition from laziness and lethargy and paying attention to social utilitarianism instead of personal benefit-seeking and with rejection of moral vicious acts like fraud and misrepresentation etc and creation of moral virtues including fulfilment of promises and treaties, honesty and equity, justice and benevolence and the like on the other hand, they may create the atmosphere of trust and transparency of information and reduction of opportunism and play effective role in lowering transaction cost in Islamic contract by stipulation of appropriate moral sanctions and guarantees for contracts.

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