



**INTEGRATING THE THIRD SECTOR INTO A THREE-
SECTOR ECONOMIC FRAMEWORK: TOWARDS
ENHANCING SOCIAL WELFARE IN AN ISLAMIC
ECONOMY**

BY

BUSHRA ABU SAIID

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ABSTRACT

This dissertation attempts to fulfil three research gaps in relation to the third sector from an Islamic economic aspect. It tackles the lack of adequate understanding of the importance of the third sector as a key part of the economy, the lack of a systematic conceptualization of the sector, and the lack of a framework integrating the sector in the economy for social welfare provision. The study undertakes two main kinds of methodology, a critical review of the literature on the third sector and an integrative analysis synthesizing adopted Islamic and Western literatures. The study consequently explores the diverse contemporary third sector concepts and frameworks to establish a unifying concept of the sector. It further presents a systematic structure of a three sector economy with the third sector as an integral component in an Islamic economic system. Towards the development of such a macroeconomic framework, it looks at both historical and present-day roles and the importance of the third sector from an Islamic economic context. It additionally proposes a three-sector economic model with a well-defined scope and characteristics of the third sector while detailing how the economic sectors should cooperate and interact towards the realization of public welfare (*maslahah*) and Islamic economic goals. The second part of the dissertation describes the interaction of the third sector with all sectors in a three-sector economy for social welfare provision. It presents a modified income flow model showing the movement of income transfers and welfare services around the economy. To complete the macroeconomic framework, it lastly suggests a practical *maqasid-al-shari'ah* based resource allocation tool led by an Islamic Third Sector Commission (ITSC) to assist third sector organizations (TSOs) as well as other economic sectors in better social welfare provision. The overall macroeconomic framework is expected to provide a better understanding of this uniquely complex and fundamental sector for the benefit of OIC countries in establishing a more sustainable third sector and for improving social welfare.

خلاصة البحث

هذه الرسالة تحاول تحقيق ثلاث فجوات بحثية فيما يتعلق بالقطاع الثالث من الناحية الاقتصادية الإسلامية. ويعالج الافتقار إلى الفهم الكافي لأهمية القطاع الثالث بوصفه جزءاً أساسياً من الاقتصاد، وعدم وجود تصور منظم للقطاع، وعدم وجود إطار يدمج القطاع في الاقتصاد من أجل توفير الرعاية الاجتماعية. وتتولى الدراسة نوعين رئيسيين من المنهجية، مراجعة نقدية للأدبيات المتعلقة بالقطاع الثالث، وتحليلاً تكاملياً بالمفاهيم والأطر المختلفة للقطاع. بناءً على الجمع بين الآداب الإسلامية والغربية المعتمدة على ذلك تستكشف الدراسة المفاهيم والأطر المختلفة للقطاع الثالث المعاصر من أجل وضع مفهوم موحد للقطاع. كما تقدم بنية نظامية لاقتصاد ثلاثة قطاعات مع القطاع الثالث بوصفه عنصراً مكملاً في نظام اقتصادي إسلامي. نحو تطوير مثل هذا الإطار الاقتصادي الكلي، فإنه ينظر إلى كل من الأدوار التاريخية والحالية وأهمية القطاع الثالث من السياق الاقتصادي الإسلامي. بالإضافة إلى ذلك يقترح نموذجاً اقتصادياً من ثلاثة قطاعات بنطاق وخصائص محددة جيداً للقطاع الثالث مع توضيح كيفية تعاون القطاعات الاقتصادية وتفاعلها مع تحقيق الرفاهية العامة (مصلحة) والأهداف الاقتصادية الإسلامية. يصف الجزء الثاني من الرسالة تفاعل القطاع الثالث مع جميع القطاعات في اقتصاد ثلاثة قطاعات لتوفير الرعاية الاجتماعية. ويقدم نموذج معدل الدخل المعدل الذي يوضح حركة تحويلات الدخل وخدمات الرفاه في جميع أنحاء الاقتصاد لإكمال إطار الاقتصاد الكلي، يقترح في النهاية أداة لتخصيص الموارد تستند لمساعدة منظمات (ITSC) إلى مقاصد الشريعة، تقودها لجنة القطاع الثالث الإسلامية وكذلك القطاعات الاقتصادية الأخرى في تحسين الرعاية (TSOs) القطاع الثالث الاجتماعية. تقديم. ومن المتوقع أن يوفر الإطار الكلي للاقتصاد الكلي فهماً أفضل لهذا القطاع الأساسي المعقد بشكل فريد لصالح البلدان الأعضاء في منظمة المؤتمر الإسلامي في إنشاء قطاع ثالث أكثر استدامة وتحسين الرفاهية الاجتماعية.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Economics.

.....
Mohd Nizam Barom
Supervisor

.....
Mustafa Omar Mohammed
Co-Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Economics.

.....
Mohd Nahar Mohd Arshad
Examiner

.....
Mohamed Aslam Haneef
Examiner

This dissertation was submitted to the Department of Economics and is accepted as a fulfilment of the requirement for the degree of Master of Economics.

.....
Mustafa Omar Mohammed
Head, Department of Economics

This dissertation was submitted to the Kulliyah of Economics and Management Sciences and is accepted as a fulfilment of the requirement for the degree of Master of Economics.

.....
Hassanuddeen Abd. Aziz
Dean, Kulliyah of Economics
and Management Sciences

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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For the sake of Allah (SWT),

And to my beloved parents,

Abu Saiid Md Abdul Majid and Herun Nahar

For their endless love, support and sacrifices.

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In the name of Allah, the Most Gracious, the Most Merciful

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LIST OF ABBREVIATIONS

TS	Third sector
TSOs	Third sector organizations
NGOs	Non-governmental organizations
NPOs	Non-profit organizations
GCC	Gulf Cooperation Council
CSR	Corporate social responsibility
ITSC	Islamic Third Sector Commission
OIC	Organization of Islamic Cooperation

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The present modern economy today is predominantly made up of two sectors, the state or government (public sector) and the market (private sector) such that we live in a two-sector world whereby the third sector remains rather unfamiliar as a distinct sector. Salamon (2010) relates the relative ‘invisibility’ of the sector to it being poorly understood due to insufficient information on its basic scope, structure and contribution. The term ‘third sector’, said to have emerged in the early 1990s, is often synonymously referred to as the voluntary sector, the non-profit sector, not-for-profit sector, the charitable sector, the community sector, the philanthropic sector, the intermediary sector, the citizen sector, the civil society, the social economy or even simply a ‘third way’. Presumably sitting between the public and private sectors, it is made up of a wide range of institutions and activities such as NGOs, charities, foundations, cooperatives and social enterprises to name a few. From an Islamic stance, it further includes institutions and undertakings such as *awqaf*, *sadaqah*, *zakah*, *qard hasan*, Islamic microfinance, and Islamic cooperatives among others. The concept of a third sector has long been ingrained in the history of Islam and in fact the Holy Qur’an itself outlines charity as an old institution. Since historical Islam, volunteerism has thereafter been regarded as a socially obligatory duty.

The public and private sectors are for the most part regarded as responsible for dealing with the production, consumption and allocation of resources in an economy. At one end, free market or capitalist economies give precedence to the private sector

with minimal restrictions placed by the public sector and at the other end, there exists planned economies where the government plays the primary role in the economy, taking responsibilities of most economic activities whilst limiting the private sector. In practice, the extent of these freedoms, limitations and interactions between the private and public sector differ from country to country.

This mainstream two-sector economic framework has however been said to have some inherent concerns that has been resulting in its failure to effectively realize socio-economic goals and to sustain development in both developed (Weisbrod, 1988; Kendall & Knapp, 2000; Steinberg, 2006) and developing economies (Molla & Alam, 2013; Arshad & Haneef, 2016). Why is this the case? The public sector is often considered to be inefficient and inequitable while the private sector is rather deficient in meeting social welfare goals and instead tends to contribute to income inequalities and social divides. Certain societal needs are left unfulfilled owing to their market unprofitability. Meanwhile they may also be too expensive to fulfil or simply neglected from the governmental aspect. An additional noteworthy shortcoming of the current system relates to the lack of an adequate value component in the framework. This is brought to attention by several studies (Westall, 2009; Arshad & Haneef, 2016). One such study stresses that, “incorporating ethics into economics would lead to better policy, improve theory and give economics a broader and more humane focus” (High, 1985, p.12.). These limitations and drawbacks of the two-sector economy has essentially created a niche for a value based third sector to fill in the gap between the public and private sectors and act as an alternative resolution. Hansmann (1987) highlights the three significant rationales for the emergence of the third sector, firstly, as a response to the two-sector failure, secondly, due to social or religious based

entrepreneurial initiatives and thirdly as a result of collaborative partnerships between the public and private sectors.

While the sector is presently regarded as a relatively modest and indistinct part of the economy, its existence cannot be denied as innumerable voluntary organizations ranging from small informal groups to large sophisticated international aid organizations, whether faith-based, political based or as part of a civil society, exist worldwide. The unique nature of the third sector of being unlike either the market or the government, yet characterised as private, flexible, serving public welfare and its close link with citizens has created a vast array of organizations and activities all over the world. Rising globalisation has further spurred the growth of the sector (Salamon, 2005). Studies on the third sector in numerous countries have concluded that it is a far larger and more influential sector than realised, with diverse variations in size, scope and concept, overall contributing to significant socioeconomic development (Salamon, Hems & Chinnock, 2000; Salamon, Anheier, Toeplar & Sokolowski, 1999). The sector in some cases has even outperformed other economic sectors (Bacchiega & Borzaga, 2003). A look at some figures indicate the magnitude and influence of the sector. The year 2015 saw a total voluntary giving of about 43.8 billion pounds in UK (Charity Today, 2017), Australia's third sector had a turnover of 134.5 billion dollars in 2015 (ACNC Media Release, 2016) and American voluntary contributions reached 390.05 billion dollars in 2016 (Giving USA, 2017). The third sector also prevails in the OIC region where globally it donates up to 1 trillion dollars on an annual basis with the GCC area alone giving about 15 to 20 billion dollars yearly (GIFR, 2012). The sector's contributions are therefore quite apparent; the relative invisibility however lies in its inadequate formalisation, institutionalisation, and harmony with other sectors as well as an absence from official national accounts and statistical systems both in the Western

(Salamon, 2010; Monzon & Chaves, 2008) and even more so in OIC countries (GIFR, 2012; Ibrahim & Sherif, 2008). For this very reason, the third sector today is sometimes regarded as a 'sector hidden in plain sight'.

The importance of a three-sector economy has been particularly highlighted in terms of it allowing for a greater socially optimum allocation of resources (Ziauddin, Munawar & Fahim, 1983). Resources from the third sector play a major role in social welfare in an economy. Empirical studies indicate that a significant portion of the resources for economic development and the curbing of poverty come from Islamic voluntary acts (Hamdani, Ahmed & Khalid, 2004). In this aspect, allocation of resources in an economy is a particularly critical decision which can have implications on the distribution of real output and the total societal welfare as stressed by Faridi (1983).

It must be noted that in spite of its many tributes, the third sector as per the conventional economic theories, has its own failures particularly if it is to function completely independent of the other sectors, among them are its inability to mobilize enough resources on a consistent basis for the provision of services, its discriminatory actions in favoring a select few individuals or groups of society over others, corruption and control of social capital by the privileged as well as ineffective measures undertaken to resolve societal concerns (Salamon, 1987; Crampton, Woodward & Dowel, 2001). This points to the fact that the third sector may be incapable of fully substituting the public sector in fulfilling societal welfare and most likely cannot function in isolation of other sectors but rather plays a complementary role with their support and cooperation. Since the sector has so far been regarded as a side player without proper institutionalization, studies like Kolin (2009) call for the need for an integrative system with all three sectors of the economy participating under the welfare system. The

concern of inadequate resource distribution and mobilization through the third sector has also been observed as one of the major drawbacks of contemporary third sector practices, both in the Western sphere in relation to third sector failures (Salamon, 1987) and in muslim societies (GIFR, 2012; Ismail & Shaikh, 2017) who face ineffective allocation of philanthropy among welfare sectors. This acts as a hindrance towards enhancing the sector's potentials and in sustaining better social welfare provision in an economy.

Despite its importance and vital role in the economy, the sector is still largely viewed in isolation from the other sectors and its potentials are not realized enough. One reason as put forward by Faizli (2013) and Evans and Shields (2000) could be that it is commonly misconstrued that the sector is in conflict with the public sector in spite of the fact that in reality, it could not only complement and strengthen both the public and private sectors, but prove to be a potential savior in providing social welfare as a better substitute for public and private welfare provision. More so, it could significantly lower the burden of the public sector and work in conjunction with the private sector for greater efficiency and stability of the economy. Another reason is that it has been widely believed that the third sector can best assume a traditional charity role rather than playing major economic roles alongside the primary and secondary sectors, it has hence mostly been excluded from modern economic frameworks and its potentials restricted. In practice as well, third sector organizations (TSOs) predominantly focus their activities on meeting specific social goals and are usually inclined to avoid delving into economic matters (Molla, 2012). The lack of proper formalization of the sector has been further heightened by the complex and often informal qualities of the sector, not to mention the legal obstacles owing to different governing systems in different countries (Salamon, 2010).

From the Islamic stance, despite the sector having a rich profound history in both its social and economic contributions in the history of Islam, over the years, from being a major part of society, it was suppressed (Bremer, 2004; Bikmen, 2008) as the state and the private sector took over due to a shift towards centralization. Since then, although the sector still maintains its customary charity roles, its integration with other economic sectors and its institutionalization has been minimal in comparison to its level of success in the past. Ever since its decline, it has made a recent return around the 20th and 21st centuries. The concept and scope of the sector today varies among different regions and with differing levels of hybridity and relations with other sectors. But where does the third sector really stand in an Islamic economic system and moreover, is there a potential for reaching a unified concept of the sector? Where is its place in the economic system exactly and how does it interact with other sectors? One of the main targets of the third sector both from the Islamic and Western aspect is social welfare provision. This hence also raises the question of how the third sector interacts in a three-sector economy for social welfare provision. Considering the significant volume of resources that flow through the sector, why isn't it placed as a distinct sector in the circular income flow model? More so, how do resources of welfare provision, in the form of income and goods circulate the economy?

1.2 STATEMENT OF THE PROBLEM

Numerous studies have stressed on the limitations of the two-sector economic model and its inability to sustain socioeconomic development in the absence of a broad-based formally established third sector integrated with the other sectors (Weisbrod, 1988; Dollery & Wallis, 2002; Molla & Alam, 2013; Arshad & Haneef, 2016). It is believed that the third sector can play a significant socioeconomic role by complementing the

public and private sectors and effectively tackling the shortcomings of the standard two-sector economy. The past few decades has thereafter seen a sudden rise in third sector activity and research with increased advancement in countries with an extensive history of the third sector and clear beginnings of growth in areas with minimal third sector practice. This can be attributed to various considerations, from globalisation and innovative technologies, to two-sector deficiencies and greater availability of resources and philanthropy. Despite this, not enough is understood and clarified about its components, workings and how it harmonizes with the public and private sectors of the economy. This lacking is particularly found in the OIC region (GIFR 2012). A rapidly growing literature can be found from the conventional perspective on the sector's role, importance and rationality as well as on its scope, characteristics and constituents. Today, a multitude of third sector conceptualizations exist, brought forth by different country experiences and moulded by a mix of ideological, cultural, historical, legal and political influences. Challenging though it is to reach a widely agreed definition and conceptualization due to the enormous diversity of the sector, a few researches such as the John Hopkins Comparative Non-profit sector project by Salamon and Anheier (1997) and the 'Third Sector Impact Project' led by Salamon and Sokolowski (2016) has attempted to reach a consensus conceptualization of the European third sector.

On a similar path, many studies have been calling for the need for its more extensive inclusion into the economy and providing theoretical concepts of an expanded third sector (Evans & Shields, 2000; Macmillan, 2013). A few European based works further attempt to develop a three-sector economy framework as an alternative to the present two-sector economic framework. Evers and Laville (2004) work on the restructuring of a third sector as an open, pluralistic and intermediary third sector within an economy. Defourney and Pestoff (2008) attempt to conceptualize the third sector in

Europe by studying and recording the different concepts, practices and progression of the voluntary sector in different European nations in order to present a consolidated and more accurate concept of a third-sector economy. Billis (2010)'s study looks at the core elements and foundations of sectors in an effort to develop a model of hybrid organizations inclusive of the third sector and other sectors together within the economy. Ghilchrist and Butcher (2016) discuss a three-sector solution for Australia in tackling social welfare. From the Islamic viewpoint, even more limited works are available. One such study (Molla & Alam, 2013) stress on the need for going beyond basic cooperatives and working towards establishing the third sector further, conceptually and operationally through Islamic entrepreneurship. An important contribution in this area is the call for a systematic and formal conceptualization of the third sector within a three-sector economy (Arshad & Haneef, 2016). The sector is expected to be more superior through the incorporation of Islamic values and institutions and therefore have greater potentials for sustainable socioeconomic development.¹

Even conventional studies today (Westall, 2009) point to the importance of examining values in relation to the third sector and testing its practical compatibility and implications. High (1985) as well highlights on the value and ethics component of economics as a means to improve economic frameworks and policies.

¹ This dissertation was inspired and benefited from the findings of a research project conducted by IIUM's Centre for Islamic Economics (CIE), 'Exploring the Conceptual & Practical Dimensions of a 3 Sector Socio-Economic Transformation Model (3s SETM) for Malaysia,' funded by the Exploratory Research Grant Scheme (ERGS) of the Ministry of Education Malaysia, in which the cited work here by Arshad and Haneef (2016) was one of its output. The research team was headed by CIE's Director Prof. Dr. Mohamed Aslam Haneef, with Assoc. Prof. Dr. Mohd Nahar Mohd Arshad, Assoc. Prof. Dr. Mustafa Omar Mohammed, Assoc. Prof. Dr. Gairuzazmi Mat Ghani and Dr. Mohd Nizam Barom as co-researchers.

Considering that to date, third sector conceptualization is still being studied and since its nature and concepts tend to understandably differ among countries, the few attempts at coordinating the practices and seeking to unify them to lay the foundation for a clearer third sector concept that is reintegrated within an economy is a crucial first step, one that has yet to be done comprehensively from an Islamic economic context. Promoting and formally instituting the third sector could essentially open the door to many opportunities especially in terms of achieving greater sustainability and achieving fundamental economic objectives. This is particularly critical considering the shortcomings of the two-sector model as well as due to the lack of the incorporation of ethical and value components in the framework.

Islamically, the presence and active role of a third sector in an economy is naturally expected as such a sector holds a central tenet in Islam with both sharing similar values, objectives and principles (Salih, 2002; Alterman & Hunter, 2006; Zaenal & Ismail, 2014; Molla, 2012). Compared to the available Western researches, relatively limited modern scholarly attention has been however directed at the role and importance of the third sector as a key component of the third sector from an Islamic standpoint. This is particularly apparent when looking at the English literatures on the third sector. Considering the historical experiences, status given by Islam and inherent role of third sector related activities in an Islamic economic system, the question of its role, status and relevance in today's Islamic economic system arises. For the sector to flourish as a vital part of society, maximize social welfare and for it to be major part of a country's policies and national agendas, it further necessitates in-depth research in terms of well-defined scopes, characteristics and concepts. In accordance to Islamic precepts, the third sector is expected to be playing an independent but complementary role integrated within a three-sector economic framework. While, this requirement has been garnering

interest, there is an absence of a systematic macroeconomic framework of a three-sector economy aimed at attaining Islamic economic objectives. According to the Global Islamic Finance Report (2012), although third sector activities has been on the rise in the Arab World, overall, it has still yet to be adequately institutionalized and lacks a strong, robust voluntary sector.

In the mainstream circular flow of income model, the third sector is additionally not shown separately with welfare resources flowing through it and around the economy. Rather, depending on the nature of TSOs and their sources of support, TSOs are classified in national statistics and accounts either under the private or public sectors and sometimes under the household sector (Salamon, 2010), especially since they are sometimes complex hybrid organizations overlapping between economic sectors. Agard (2010) explains that non-profits remain under the private sector performing as social welfare organizations correcting market imperfections. Meanwhile, the public sector intercedes to strengthen and supplement the role of non-profits in the market by regulating and balancing income flows in the circular flow model. The third sector is consequently not recognized as a distinct sector with a depiction of its balance of flows and its interaction with other sectors in the economy. The recognition and addition of the third sector within the income flow models in an economy has become increasingly relevant based on the significant flows of income that flow to the third sector and through TSOs for the social wellbeing of the society. At the end of the day, the basic circular flow of income model doesn't adequately capture the flows of monetary and non-monetary social welfare resources around the economy. The problem statement is summarized in Figure 1.1.

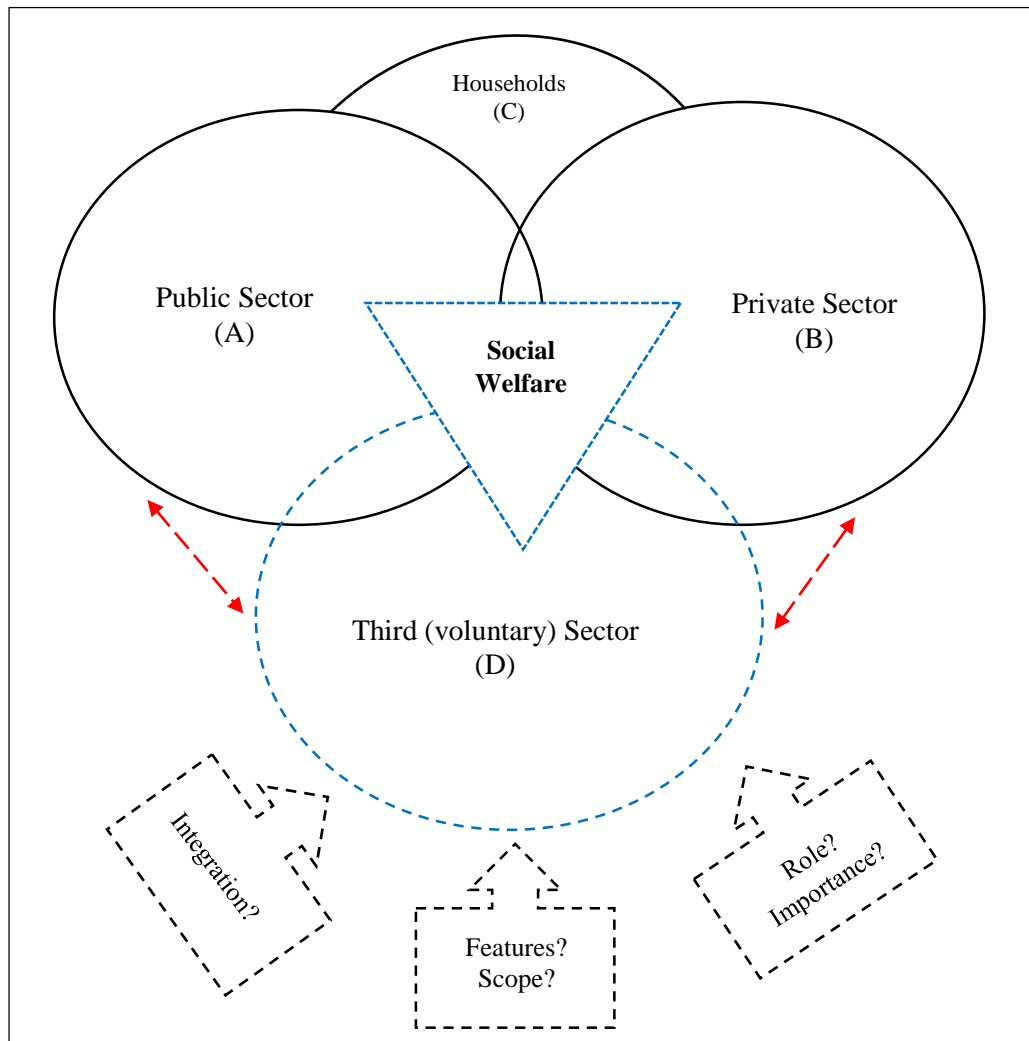


Figure 1.1 Diagrammatic Illustration of the Statement of Problem

It shows the two-sector model predominant in economies today made up of the public (A) and private (B) sectors. The household (C) sector is shown as inherently connected to both the private and public sectors, even if not always distinctly shown in a typical mainstream economic framework.

The three dotted block arrows in figure 1.0 consequently depicts the three research gaps that this study attempts to fill. The first gap is the lack of adequate understanding of the role and importance of a third sector as an integral part of the economy,