

Fitting Islamic Financial Contracts in Developing Agricultural Land

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Abstract

The Islamic finance industry is one of the fastest growing industries in the world. However, many potential Muslim customers, particularly in rural areas, have unfulfilled banking needs and lack access to financing. Meanwhile, entrepreneurial projects in the agricultural sector are presumed to optimize economic growth. In addition, some scholars have expounded that the financial problems faced by the agricultural sector are caused by the risks of debt financing and lack of access to the capital market. In Islamic law, *al-muzara'ah* and *al-musaqah* can be considered as forms of partnership contract in farming. Therefore, using descriptive analysis, this paper attempts to portray how Islamic financial principles are closely related to the agricultural sector in developing Islamic agricultural finance. This study found that the application of the modes of Islamic financing in the agricultural sector through financial institutions could be very effective in providing financing to ensure that the partnership progresses effectively and efficiently. As a result, there is an urgent need to develop a sound agricultural financial system based on Islamic contracts in order to increase and sustain the income of farmers and landowners and to reduce poverty.

Keywords: Agricultural land development; *al-muzara'ah*; *al-musaqah*; Islamic financial contracts; Islamic partnership

Introduction

It is undeniable that many Islamic countries in these days have rural economies. In general, small farmers in a lot of Islamic countries are in thorny circumstances. For instance, they suffer from liquidity problems, which greatly reduce the efficiency of their farms. In addition, they also do not have huge access to organized credit markets. Consequently, it is not surprising that an informal credit market, which charges a much higher interest rate, exists alongside the formal credit markets (Hoff et al., 1995).

Besides that, it is also a matter of fact that the development of agricultural land requires huge capital injections that normally exceed farmers' income. Financial capitals are essential to finance agricultural infrastructure including the purchase of seeds, machinery, irrigation and fertilizers. In the meantime, Islamic banking and finance institutions are growing rapidly in these days. However, there are still many potential Muslim customers, particularly in rural areas, whose financial needs are not being met. Under these conditions, the introductions of a financial system which can grant special facilities to the small farmers are needed, as well as improving the availability of agricultural finance in order to help farmers to increase their agricultural production activities (Hughes et al., 1986).

Thus, this paper attempts to portray how Islamic financial principles, particularly those contracts

that are closely related with the agricultural sector, may create an alternative in developing Islamic agricultural finance. Furthermore, the suitability of Islamic agricultural finance and the proposed schemes of Islamic partnership contract to develop agricultural land are also discussed.

Prospects of Islamic Partnership Contract in Agriculture

Agricultural land is valueless unless it is worked to convert it into the productive input. Therefore, flow resources such as labour, machines or tools, and seeds are needed. Sometimes, due to the absence of one or more of the input of productions, the issues of idle land might arise. In addition, there are also some authors in their theories of agriculture role, claim that agriculture is a default source of employment and a pool of reserve of labour. Meanwhile, it is indisputable that the agricultural sector especially requires long-term financing due to the long duration from sowing to harvesting (Hughes et al., 1986).

On the other hand, Islamic commercial law of the *shari'a* visibly encourages the scheme of risk and reward sharing in the society. Conventional forms of loan put the mass of risk on the borrower and not the institution, in which low-income person can end up in debt, worsening their situation and making it impracticable for them to improve the community.

Islamic financial scheme was originally created on the prohibition of predetermined payment or receipt and guaranteed rate of return. The theory of interest and debt-based instruments are eliminated in Islamic finance as the system encourages risk-sharing, promotes entrepreneurship, discourages speculative behaviour and emphasizes the sanctity of the contract (Iqbal, 1997). The constructive purposes available in Islamic finance, in addition to the expansion of the products to the poor, could be an effective development tool (Alasrag, 2010). In the meantime, Aggarwal and Yousef

(2000) divided profit and loss sharing, which are anchored in the principles of *al-mudarabah* and *al-musharakah*, into both long-term financing and the principles of *bayal-salam* and *al-ijara*, while always linking them in the short-term financing.

Consequently, Hoshmand (1995) anticipated that Islamic banking principles such as profit and loss sharing or partnership contract might offer a solution to the problems of credit availability, as well as reduce the risk of debt financing in the agricultural sector. Two reasons can be given in support of this statement. Firstly, banks would not risk their funds for highly speculative activities, and secondly, banks would have the essential incentives to promote the projects' profitability as they would be acting as the shareholders in the projects that they are financing (Crane & Leatham, 1993).

The Concept of Al-Muzara'ah and Al-Musaqahas Forms of Partnership Contract in Agriculture

In addition to the principles of *al-mudarabah* and *al-musharakah* that are widely discussed under partnership contract in Islamic banking and finance, there are also partnership contracts that are strictly related to the agricultural land development, which are *al-muzara'ah* and *al-musaqah*. *Al-muzara'ah* is a trade transaction between a capital owner and a trader, while *al-musaqah* is an agricultural partnership between a landlord and a farmer (Shafiai, 2011).

In general, *al-muzara'ah* is derived from the word *zara'a*, which means crop (Ibrahim, 1983). Therefore, it can be defined as a contract made between two people; a landowner and a farmer, whereby the landlord gives his land to the farmer to plant, maintain and cultivate against a specified joint share of the crops (Al-Syarbini, 1997; Al-Kasani, 1968; Al-Syawkani, 1985; Hasan, 1998; Bal, 2001).

Meanwhile, *al-musaqah* contract is derived from *sqaq*, which means to water or irrigate

the land (Ibrahim, 1983). Technically, this principle can be defined as a contract between the landowner of some trees and the farmer, who treats, services, irrigates and cares for the shade trees, and stipulates that the crop produced is to be shared between them (Al-Syarbini, 1997).

Nevertheless, there is a dispute among Islamic jurists that both *al-muzara'ah* and *al-musaqah* resemble leasing (*al-ijara*) or partnership contract (*al-mudarabah*). In the earlier concept of *al-muzara'ah*, Imam Abu Hanifah suggested that this principle is invalid and only acknowledged the concept of *al-ijara* (leasing). Imam Abu Hanifah, Imam Malik and Imam Shafi'i made it clear that with regard to arable lands, they considered accepting the contract of *al-ijara* (Johansen, 1988).

On the other hand, later scholars such as Imam Abu Yusuf, Muhammad al-Shaybani, Ahmad Ibn Hanbal (Nyazee, 2002) and contemporary scholars like Muhammad Baqir Sadr (Al-Sadr, 1982) and Seyyed Mahmood Taleghani (Taleghani, 1983) proposed that this principle was similar to the partnership contract and permissible. Therefore, the jurists who attribute this principle as partnership agreement view it as similar to the *al-mudarabah* contract (Nyazee, 2002).

After reviewing all arguments from classical and contemporary scholars, it can be concluded that these principles are more similar to partnership contract in farming. The principles of *al-muzara'ah* and *al-musaqah* can be considered as a joint venture between the landowner owning the property (agricultural land) and the farmer doing the work. The land and seeds belonging to the owner are viewed as the capital, and these can also be considered as a factor that enables production.

Furthermore, in a partnership contract, the profit or loss, as well as risk are shared by both parties. If there is no crop, the loss is borne equally; the landowner will lose his seeds and the farmer will lose his work. Thus, neither will it be in a

position to the appropriate profit exclusively. The landowner risks the enjoyment of his land, which he could have leased out for a determined rent guaranteed by a lessee, but he preferred to take risk in the hope of making profit. At the same time, the farmer risks his work, as he could cultivate the crop, but it might not yield any produce or only give a little output. He could have hired out his services for a determined and fixed wage to be paid by the landowner, but he preferred to take the risk of the benefit of his labour in the hope that he would gain more profit.

Comparing al-Muzara'ah and al-Musaqah

Principally, the contract of *al-muzara'ah* is similar to *al-musaqah*. The contract of *al-muzara'ah* can be described as a partnership in farming, whereby the landlord provides the land and the farmer provides work and management from early work until harvesting. In contrast, *al-musaqah* is in the case of trees that have already sprouted (before the contract) and have grown strong, and the landlord is unable to irrigate the plants and is incapable of working the land (Shafiai, 2011).

According to Wahbah al-Zuhayli, all the relevant conditions of *al-muzara'ah* apply to *al-musaqah*. Furthermore, it was ruled by the scholars that *al-musaqah* is similar to *al-muzara'ah*, except for the tiny procedural issues due to diverse opinions among Islamic jurists (Al-Zuhayli & Eissa, 2003). Therefore, it can be concluded that *al-muzara'ah* is a contract in partnership between the landlord and the farmer in developing an agricultural land from the beginning until cultivation process. On the other hand, *al-musaqah* is more on the partnership in cultivating an orchard. In short, the only difference between these two contracts is the substances of 'land' (in *al-muzara'ah*) and 'trees' (in *al-musaqah*).

Suitability of Islamic Partnership Contract in Developing Agricultural Land

In general, the need for financing is universal in human beings, whether or not it is based on non-Islamic or Islamic finance. It will need to finance the purchase of assets, employing workers and also to cover the operational costs. However, this paper attempts to highlight two main arguments supporting the suitability of the Islamic partnership contract based on the principles of *al-muzara'ah* and *al-musaqah* in order to develop or finance agricultural land.

Shari'a Compliance

Shari'a compliant finance was invented to facilitate Muslims in acquiring financial products that conform to the system of belief in their religion. Banking services such as savings accounts, financing for education, and home loans are all required by Muslims just as non-Muslims do. Historically, the establishment of Tabung Haji in Malaysia in 1963 and the first Islamic bank in Egypt in 1963 (Wilson, 1983) to the present day has proven the enormous need for *shari'a* compliant banking or financial products in rural communities. In earlier years, particularly those from rural areas, conventional methods of saving money were used to avoid *riba* and to enable them to perform hajj. They accumulated money in pillows under mattresses and this practice was very risky in terms of security.

Furthermore, according to El-Gamal (2000), a banking and financial system based on Islamic principles exists mainly to provide religiously acceptable banking services to the Muslim community. Islamic banks are also intended to be the financial institutions to assist Muslims in keeping away from *riba*, *gharar* and *maysir*, which are present in conventional banking institutions.

Long Term Profitability

Fundamentally, in Islamic banking systems,

banks are considered as organizations working with their customers' funds. Basically, Islamic banks offer two ways of banking facilities. The first is fixed profit facilities like hire purchase, instalment sale at a fixed rate of profit, which is based on the principles of *al-murabahah* and *al-bay bithmanajil* and the second is variable profit facilities, which is based on profit and loss sharing rooted in *al-mudarabah* and *al-musharakah* principles (Iqbal & Llewellyn, 2002).

Chapra (2002) argued that the stability characteristics of the financial system could be further enhanced by implementing more partnership or equity financing. Through these risk-sharing contracts, financiers would have a greater incentive in both assessing risks at the outset, and monitoring borrowers after financing has been provided (Chapra, 2002).

Therefore, based on the arguments by Siddiqi (1983) and Chapra (1992), it was envisaged that partnership contract should be the core characteristic of Islamic banking financing. They have affirmed that Islamic banks will definitely promote growth in Islamic countries by providing long-term partnership financing to the developed sectors (Siddiqi, 1983; Chapra, 1992).

Proposed Schemes of Partnership Contract for Agricultural Land Development

Basically, a financing arrangement based on *al-muzara'ah* and *al-musaqah* or partnership contract for agricultural land development can be initiated subject to joint partnership in the mobilization of land, other physical inputs and labour. In a contract based on *al-muzara'ah*, various forms of partnership can be produced. As a basis, the land and other physical factors of production for the partnership come from one party, and the labour comes from the other party (Gulaid, 1995).

Alternatively, the land can come from one party, while the other physical factors of production

and labour come from the other party. Besides that, another alternative of *al-muzara'ah* is that the land and labour come from one of the contracting parties, while the other physical factors of production come from the other party (Gulaid, 1995). Incidences of a three-party *al-muzara'ah* partnership, in which the first party provides land, the second provides a combination of required physical inputs, and the third provides labour, are common in contemporary agriculture (Shafiai, 2011).

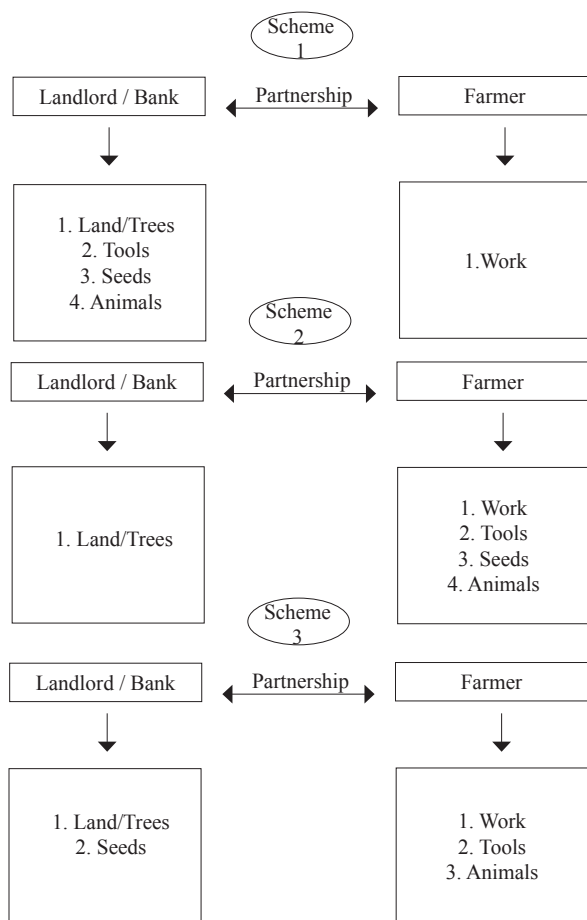


Figure1: The Basic Schemes of Partnership Contract in Agriculture between Landlord/Bank and Farmer (Shafiai, 2011)

By using the forms of contract proposed by Abu Yusuf, three schemes of partnership as shown in Figure 1 are suggested in this paper. First, the land (in *al-muzara'ah*) or trees (in *al-musaqah*), tools, seeds and animals are provided by the landowner, and the work (effort) is undertaken by the tenant. Secondly, the land (in *al-muzara'ah*) or trees (in *al-musaqah*) is provided by the landowner, and the rest is

provided by the tenant. Third, the land (in *al-muzara'ah*) or trees (in *al-musaqah*) and seed are from landlord and the rest from the tenant.

From the bank's perspective, the schemes of *al-muzara'ah* and *al-musaqah* can be applied in financing the agricultural inputs for a specified period. The bank will provide funds for the agricultural investments, while the farmer will provide the labour. Therefore, in this context, *al-muzara'ah* and *al-musaqah* contracts can be used for obtaining seeds, fertilizers, and pesticides along with the needs for irrigation, storage, and marketing activities of the agricultural commodities (Shafiai, 2011). Thus, the bank can become the landlord through the financing scheme.

Besides that, there is also a possibility for the bank to be the landlord. This can be done by the buying of the land by the banks, which will then be given to the potential farmer to cultivate it according to the partnership principle. In this case, the Islamic bank will play its role as the landowners, and the bank will also have a partnership with the farmers. Besides, in the case of landless farmers, financial institutions could first buy this land and then give it to the potential farmer to cultivate according to the principles of *al-muzara'ah* and *al-musaqah*. At the end of the contract, it is also possible for the farmer to become the landlord by making payments to the financier based on another principle like *al-ijara al-muntahia bi-tamlik*. It is also possible for Islamic banking institutions to play the roles of landowners directly and have a partnership with the farmers using the principles of *al-muzara'ah* and *al-musaqah*.

Conclusion

Accordingly, from the perspectives of Islamic banking and financial institutions, the principles of *al-muzara'ah* and *al-musaqah* have a high potential to be formulated as Islamic modes of partnership financing for agricultural land. The application of these modes in the agricultural sector could be very effective, especially for

orchard or agricultural land financing. Financial institutions could provide financing either to the landlord, the tenant or both parties to ensure that the partnership progresses effectively and efficiently.

The suggestions provided for financing the agricultural land is not limited just to the principles of *al-muzara'ah* and *al-musaqah*. However, other principles such as *al-ijara al-muntahia bi-tamlík*, *al-murabahah* and *bay al-salam* can also be included. The current Islamic banking institutions are inclined towards implementing the two-tiered *al-mudarabah*, instead of the one-sided *al-mudarabah* in classical theory. In this principle, the banks accumulate deposits from their customers and invest it to the third parties. Hence, a proper adjustment by the financial experts to the principles of *al-muzara'ah* and *al-musaqah* is relevant to improve the practicality of the transactions in Islamic banking and financial institutions. The required steps must be defined from many parties, including the academicians and practitioners for this product's improvements.

To sum up, it is necessary to make further empirical studies to further clarify the above-mentioned issues and eventually build a framework for a partnership between the landlord and the farmer from the perspective of Islamic economics. Therefore, there is an imperative need to develop a sound agricultural financial system based on Islamic contracts in order to increase and sustain farmers' and landowners' incomes and reduce poverty.

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