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Crafting the Agricultural Product and Loss Sharing (aPLS) in the Place of the Profit and Loss (PLS) for Islamic Agricultural Finance*

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Abstract

In Sharia, charging interest (*riba*) and all transactions involving risk and gambling (*maysir*) or uncertainty (*gharar*) are absolutely prohibited. Consequently, the Islamic financial solution, regularly referred to partnership contracts, proposes an equitable sharing of risks and profits between the involving parties in a financial transaction. The partnership contract in the discussion on Islamic banking and finance is closely related to the principles of *al-mudaraba* and *al-musharaka*. In contrast, there are also partnership contracts which are classified to be used in agricultural land development, namely *al-muzara'a* and *al-musaqa*. In general, the contracts of *al-muzara'a* and *al-musaqa* have a resemblance to the contracts of *al-mudaraba* and *al-musharaka*. However, the similarity of *al-muzara'a* and *al-musaqa* to *al-mudaraba* and *al-musharaka* is not in substance but is in concept of the contract. This is because the *al-muzara'a* and *al-musharaka* contracts focus in agriculture, while *al-mudaraba* and *al-musharaka* are more suited to trade and commercial contracts. Therefore, *al-muzara'a* can be identified as “agricultural product and loss sharing” (aPLS) and *al-mudaraba* and *al-musharaka* as “profit and loss sharing” (PLS). As a result, an Islamic partnership contract by the financial institutions for agricultural land development ought to implement aPLS which is based on the principles of *al-muzara'a* and *al-musaqa*.

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** Ph.D Student, Graduate School of Asian and African Area Studies (ASAFAS), Kyoto University, Japan; Lecturer, Faculty of Economics and Management, The National University of Malaysia (UKM), Malaysia. E-mail: hakimi_68@yahoo.com.my

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1. Introduction

For developing countries, agricultural development is crucial and no less significant than industrialization. For Islamic countries, such as Malaysia and Indonesia, there is another imperative not found in non-Muslim countries, that is, how to conduct economic development in a manner compatible to their Islamic and other cultural values.

This paper investigates the possibility of agricultural development utilizing Islamic financial schemes. While the present author is doing research in Islamic agricultural finance in the Malaysian context, this paper is more general and theoretical and does not refer to the case of Malaysia.

Islam is known to be principally concerned with the morality and fairness of economic activities, especially regarding business transactions. In Sharia, charging interest (*riba*) and all transactions involving risk or uncertainty (*gharar*) are absolutely prohibited. Islam also prohibits intentionally seeking risk, as in gambling.

All of the above were prohibited because they favor one party against the other, meaning that they involve the potential for one party to acquire all the benefits and the other party to bear all the losses. Thus, the main aim of IBF is to provide an Islamic alternative to the conventional system that is mainly based on *riba*.

The theory of Islamic banking which is derived from the philosophies of Islamic economics can be best highlighted in terms of the role it can play in the development process as a mobiliser and employer of capital funds in ways that contribute to the productivity and growth of the economy. Islamic finance offers the alternative of a profit-sharing rate as the basis for rewarding and allocating funds among users.

Therefore, the initial theoretical structures of Islamic banking proposed by Islamic scholars, particularly since 1950s to 1960s, were built on the concept of profit and loss sharing (PLS) based on the principles of *al-mudaraba* and *al-musharaka*. However, contrary to the expectations

of this theory, it was found that Islamic banks these days rarely offer PLS instruments to their customers.

Meanwhile, the agricultural sector is generally considered as a cash constraint. Financial institutions are reluctant to lend to small farmers due to their inability to provide collateral, the higher default risks, and the high transaction costs associated with small loans. In addition, according to Yousef, (1997), the attention of the majority of Islamic banks is not focused on agriculture and small retail trade financing.

In classical Islamic jurisprudence discourses, there were specific terms or principles closely related to the partnership contract in agriculture which are *al-muzara'a* and *al-musaqa*. However these principles, as potential Islamic financial products for agricultural land development, have been marginalized in the current debates.

At the same time, several scholars claimed that the PLS contract based on *al-mudaraba* and *al-musharaka* can be implemented as a partnership contract in agriculture. These opinions are contradicted particularly on the historical view as well as on the nature of these principles which are specifically for trading transactions.

For this reason, it is really important to understand the nature of these principles in order to create appropriate Islamic financial products which meet customers' expectations. This is because the lack of a real and in-depth understanding of the basic principles of Islamic commercial law will lead to the creation of misleading Islamic financial products.

Consequently, this paper attempts to clarify the concept of a partnership contract primarily concerning the principles of *al-mudaraba* and *al-musharaka* as one group and *al-muzara'a* and *al-musaqa* as another. This is very crucial since Islamic financial products are essentially developed with reference to the principles of Islamic jurisprudence and therefore, clarification of the nature of the exact principles is obligatory.

2. Partnership Contract in Islamic Commercial Law

From the historical view, the partnership contract was an accepted legal commercial institution in the medieval Muslim world and it was assumed that this contract was expansively employed in

trade. However, this contract is not an innovation of Islamic law, because it was known and practiced in the Near East at least since the Babylonians [Udovitch, 1970: 8].

Fundamentally, the partnership contract in the discussion on Islamic banking and finance is closely related to the principles of *al-mudaraba* and *al-musharaka*. On the other hand, there are also partnership contracts which were classified to be used in agricultural land development, namely *al-muzara'a* and *al-musaqa*. From the historical discourses, it was found that the earlier principles are related closely to trade transactions between a capital owner and a trader and the later are more related to an agricultural partnership between a landlord and a farmer.

Nevertheless, there is also an argument that the principles of *al-muzara'a* and *al-musaqa* in fact employ the principles of *al-mudaraba* and *al-musharaka*. This means *al-muzara'a*, in which the farmer works agricultural land on a sharecropping base, is the traditional counterpart of *al-mudaraba* in farming. Meanwhile *al-musaqa*, in which an agreement is made for planting and tending fruit trees, is the counterpart of *al-musharaka* in orchard keeping,. The yield of the orchard is divided among the contracting parties in a specified ratio [Lewis and Algoud, 2001: 51-52].

Throughout the early literature of Islamic banking and finance studies, it was envisaged that a partnership contract rooted in the principles of *al-mudaraba* and *al-musharaka* also known as Profit and Loss Sharing (PLS) was to be the core characteristic of Islamic banking financing operations. It was proved through the proposal to apply the PLS scheme by Qureshi (1974), Uzair (1978) and Siddiqi (1985) in order to eliminate *riba* in banking transactions [Saeed, 1999: 2].

In addition Anwar (1987) stated that the Qur'an (al-Baqarah: 275) distinguishes the practice of *riba* from commerce in order to denounce *riba* and approved trade. Islamic scholars commend trade-oriented banking in place of conventional interest-bearing credit oriented banking. The key medium of interest-free banking is a two tier *al-mudaraba*. Furthermore, Madi (1989) affirmed that legitimate profit in Islamic law is an apparent relationship between the capital owner and the investors in the scheme of profit sharing and partnership.

Besides, Presley and Sessions (1994) argued that the profit and loss sharing scheme based on *al-mudaraba* principles, under certain conditions, enhances capital investment on account of its ability to act as an efficient financial mechanism.

Meanwhile, Hoshmand (1995) has argued that the application of a partnership contract can be an alternative method of financing for the agriculture sector in developed and developing countries. This is because, according to him, the financial problems faced by the agricultural sector are rooted in debt financing and lack of access to capital markets. In addition, farmers in developing countries not only face severe constraints in terms of access to capital markets, but also in the affordability of capital.

2.1 *Al-Mudaraba* and *Al-Musharaka*

2.1.1 History

Ray (1997) stated that the legality of a contract is accorded by the jurists due to the practical necessities of economic life, under the heading of *istihsan* (juristic preference). This can be seen in the *al-mudaraba* contract because people have a need for this contract, as with the owner of capital who may not find an opportunity to engage in profitable trading activity, and the entrepreneur who cannot engage in such activity through a lack of capital. In such cases, profit cannot be attained independently, but only by bringing together the capital and the trading activity. By permitting this contract the goal of both parties is accomplished.

Therefore, partnership contracts were the tools for combining financial and human resources for the purposes of trade and the *al-mudaraba* contract was likely developed in the context of the pre-Islamic Arabian caravan trade. The Prophet Muhammad (pbuh), in the early part of his career, acted as an agent in a partnership contract with an investment by Khadija, his wife to-be [Udovitch, 1970: 170-172]. Furthermore, indicative of this market demand, it was reported that among the early parties involved in this contract were the Prophet's wife, Khadijah, and his caliphal successors, Umar and Uthman, as well as his uncle, Abbas bin Abd al-Mutallib [Heck, 2006: 301-302]. In practice, *al-mudaraba* was utilized mainly as instrument of commerce or trade, which means buying and selling in international as well as local trade [Saeed, 1999: 52-55].

According to Gafoor (2001) *al-mudaraba* is an ancient form of financing practised by the Arabs since long before the advent of Islam. It suited the Meccan Arabs because of their location at the cross roads of the ancient trade caravans. They themselves were merchants carrying goods north to Syria in the summer and south to the Yemen in winter. They took goods from their homeport to sell at their destination, and with the proceeds bought other goods and brought them back to

sell at home and/or to re-export to another destination. When a trading caravan was organised it was the practice of the Meccans either to join it with their own goods and money or to send such through agents who did the business on their behalf. When a caravan returned home and the goods were all sold, the mission was accomplished and it was time to prepare the ‘balance sheet’ and calculate the profit or loss.

Furthermore, according to Heck, (2006), *al-mudaraba* contract had been in use since the 1st/7th century and rose to prominence in direct response to contemporary market demand. This contract became popular because the capital owner may not always have found it possible to engage in profitable trading activity, and those who could engage in it may not have possessed the capital. Yet profit could not be obtained except by both capital and trading.

2.1.2 Definition

In general, *al-mudaraba* is a contract between two contracting parties whereby one party (*rabb al-mal*) provides capital (money) to the second party (*mudarib*) to employ that money in trade. In particular, it means a contract whereby a capital owner provides his capital to be used by an entrepreneur. Any profit derived from the business is shared by both parties according to their pre-agreed ratio. Any financial loss shall be borne by the capital owner while loss of effort shall be borne by the entrepreneur [al-Zuhayli, n.d.: 836].

In addition, it is also can be described as a partnership in profit, not in capital. It is based on one side providing the capital and on the other side providing work in trade. The two sides are partners in the profit or loss. The point behind such a partnership is that there are people who have money but are not skilled in trade, and there are others who are experienced in trade but do not have the necessary capital. So, by joining them, that is by bringing together the capital from the first side and the work from the other, there should be great benefit for both parties and for the community [Kharofa, 2000: 178].

Meanwhile, *al-musharaka* is a contract between two or more parties to engage in a specific business or investment project. Each party provides a portion of the capital and shares in the profit or loss according to proportion of their capital investment and both parties have the right to participate in the management of the business.

Usmani (1999) also defined an *al-musharaka* contract as a joint enterprise in which all the partners share the profit or loss of the joint venture in the context of business and trade. He also stated that this word originated from the Arabic word which means collaboration. This contract is applicable to project financing, import and export financing, and working capital financing.

Therefore, it can be said that an *al-mudaraba* contract is a profit sharing agreement and an *al-musharaka* contract is a joint venture between a capital owner and an entrepreneur.

2.1.3 Capital in *al-Mudaraba* and *al-Musharaka*: Currency (Money)

In the framework of Islamic economics, finance capital is not a separate factor from production as in the modern economic system. Moreover, in Islamic economics, capital is actually considered as a part of the enterprise. Therefore, through the merger of capital with enterprise, we can build up the conceptual structure of an interest-free banking system [Uzair, 1978: 4].

Akhtar, (1993) had argued that capital is the factor that finances the production course. It consists of diverse monetary forms and assets. Capital in Islamic tenets cannot remain idle and earn a fixed return without being involved in the production process. Therefore, capital is a factor of production that must enter into the contractual arrangements with the entrepreneurs.

Furthermore, according to Siddiqi, (1973), the capital owner must be a partner in the enterprise [Siddiqi, 1973: 145]. This means an ideal Islamic firm is based on the unity of labor and capital as partners rather than on the basis of an employer and an employee.

Moreover, the enjoyment of a return by financial capital is justified only by the service to society provided by sharing risk inherent in the productive process [Mills and Presley, 1999: 12].

Profit in Islamic economic thinking is inherently associated with the responsibility of decision making. Managerial or entrepreneurial responsibilities may be carried out by the owner of capital or by labor [Kahf and Tariqullah, 1992: 36].

As for capital in *al-mudaraba* and *al-musharaka* contracts, all Islamic legal schools agree that the dinar (gold currency) and the dirham (silver currency) can be described as absolute currencies that are valid as a capital in these contracts [Saleh, 1986: 104-105] [Nyazee, 2002: 258]. Saeed, (1999) mentioned that the amount of capital in the *al-mudaraba* contract must be

specified to avoid any dispute between contracting parties. This can be recognized if the amount of capital is stated in currency units [Saeed, 1999: 52].

Usmani (1999) also mentioned that most Islamic jurists opined that the capital invested by each partner must be in liquid form. It means that the capital in the *al-musharaka* and *al-mudaraba* contract can be based only on money, and not on commodities. In other words, the share capital in the joint venture must be supplied in a monetary form.

2.1.4 Al-Mudaraba and Al-Musharaka as Form of Profit and Loss Sharing (PLS)

Al-Mudaraba or *Qirad* or *al-muqarada* are used to define a profit-sharing contract in Islamic traditional practice. It was also known as *commenda* during mediaeval Europe (Udovitch, 1970: 171-172). In addition, both parties in the *al-mudaraba* contract are required to be responsible and cautious in undertaking partnership contracts [Bacha 1997].

According to Siddiqi, (1985) the principles *al-mudaraba* and *al-musharaka* are very similar because the provider of finance directly shares the profits and also risks the possibility of losses, to the extent of their investment. This is why these two principles are often put together into one category known as profit and loss sharing (PLS). In Islamic banking and finance, through the implementation of PLS, the profit entirely depends on the productivity of the project which has been running as a partnership between an Islamic bank and an entrepreneur [Siddiqi, 1985: 15-16].

In parallel, Khan, (1995) also argued that *al-musharaka* is different from *al-mudaraba* in at least one respect. In *al-mudaraba*, the owner of capital has no right in the management of the project in which his finance is being invested. In contrast, in *al-musharaka*, the owner of capital has a right to be involved actively in the management. Otherwise, these two principles are very similar in that the provider of capital directly shares the profits and is willing to bear the losses. Therefore, these principles are often put together in one scheme known as Profit and Loss Sharing (PLS) [Khan, 1995: 81].

2.2 *Al-Muzara'a and Al-Musaqa*

2.2.1 History

The Qur'an, the first primary source of law for all Muslims, does not cite *al-muzara'a* and *al-musaqa* as such. In addition, the *Sunnah*, as the second of the primary sources of Islamic law, does not give a clear ruling on whether or not partnership in agriculture is permissible for Muslims.

The Prophet (pbuh) only said to the Jews of Khaybar on the day of conquest of Khaybar; "I keep you on the land on which God has kept you, on the condition that the fruit will be equally shared between you and us" [Imam Muslim 2000: No. of hadith 3939; Abi Dawud 1988: No. of hadith 3408; Abdullah Alwi 1997:100].

To deal with the dilemma, the jurists of the various Islamic legal schools (*madhhabs*) have imposed conditions and restrictions upon *al-muzara'a* and *al-musaqa* contracts in order to make the contracts valid.

Historically, the debate on *al-musaqa* contract is based on the history of Khaybar as well as the history of *al-muzara'a* contract. To be more specific, Khaybar was an oasis town in Arabia which was conquered by the Muslims led by the Prophet (pbuh) in the year 629. The jurists claim that after its conquest its tillers were reduced to the status of tenants, and the Prophet (pbuh) concluded a contract with them in which they were allowed to continue tillage of the land and receive half of its produce. This historical deal of Khaybar, therefore, has given rise to the debates on the concept of *al-muzara'a* and *al-musaqa* [Haque, 1984: 52].

In the eight and early ninth century, *al-muzara'a* was criticised on religious grounds. This was from the interpretation of Islamic ethics in the Prophet's example which implied that a Muslim could enjoy the economic benefits only from a piece of land that he tilled, and not from one he could not cultivate because the Prophet (pbuh) said: "Till it or grant it free of charge to your brother". [Johansen, 1988: 52-53].

2.2.2 Definition of *Al-Muzara'a* and *Al-Musaqa*

Al-muzara'a is derived from the word “*zara'a*”, viz. crop [Ibrahim Madzkur 1983: 401]. *Majalla al-Ahkam al-'Adliyya* in section 1431 defined *al-muzara'a* as a contract made between two people, one a landowner and the other a farmer, whereby the landlord gives his land to the farmer to cultivate against a specified joint share of the crops [Tyser *et.al.* 2001: 237].

In principle, it also means an agreement for the cultivation of land in return for part of the produce in accordance with conditions stipulated by law, when a farmer agrees with the landlord on a particular percentage to be obtained in exchange for work on his land. Farming operating costs are shared by the farmer and the landlord, proportionally.

For this reason, it is defined as a joint venture or partnership in farming, whereby one or more individuals enter into a contract to invest in an agricultural enterprise or operation. Output or produce from the agricultural venture is shared between the partners in accordance with the agreement, stipulated in the contract. The terms and conditions of a contract of joint venture should be so designed as to avoid any possibility of dispute during the conduct of business or at the time of sharing the profits or bearing the loss.

Meanwhile, the word *al-musaqa* is derived from *saqa*, to water, or irrigate the land [Rohi al-Ba'albaki 1995: 636]. *Majallah al-Ahkam al-'Adliyya* defines it as a contract between the owner of some trees and the farmer who treats, services, irrigates and cares for the said trees, and stipulates that the fruit produced is to be shared between them [Tyser *et.al.* 2001: 238].

A specific or predetermined share of the expected output, a third or a half, will go to the provider of labor and expertise. This will be clearly posited in the contract. Even though this is the consensus of the majority of the *fuqaha*, the position of the Maliki school is that *al-musaqa* could also involve crop enterprises besides orchards/trees [Ibn Rushd 2002: 640].

In other words, the contract of *al-musaqa* means that a person agrees with someone that for a specified time, the fruit-bearing trees owned by him, or those which are under his discretion, will be assigned to that person so that he cares, tends and waters them. In return, that person will have the right to take an agreed quantity of the fruits harvested [Al-Sharbini n.d. b: 136; Bosworth, C.E. *et al.* 1993: 658].

2.2.3 Capital in *Al-Muzara'a* and *Al-Musaqa*: Land and Seed

The basis of this debate is to what degree land is deemed to be capital which is exposed to profit and loss in the way that other capital like money is. The major question on these principles is it being a contract in which the tenant contributes his labour and works on the capital (land) supplied by the landlord on the correlation of *al-mudaraba* (sleeping partner in business) in which a worker employs capital advanced by a capital owner for a certain share of the profit which is yet non-existent and indefinite.

Imam Abu Hanifah argued that land cannot be considered as capital. This is because, according to him, no loss can occur in land and it cannot be a basis for entitlement to profit. As *al-muzara'a* is the sharing of profit, the owner of the land cannot be allowed to benefit from the yield or output because his land is not subject to any loss [Nyazee, 1997: 281].

On the contrary, Abu Yusuf has regarded the contract of *al-muzara'a* as analogous to the contract of *al-mudaraba*, a partnership of capital and labor. In this matter, he equates the bare land in the contract of *al-muzara'a*, with the capital in the contract of *al-mudaraba*. He also observes that the material base of the capital is present in *al-mudaraba* contract, where labor is supplied for a certain portion of the profit which may or may not be realized. He also argues that the proportionate share of the farmer in *al-muzara'a* and *al-musaqa* contracts is not known unless the actual crop is harvested. In addition, Abu Yusuf also stated that the seed contributed by the landowner should be considered as his capital [Nyazee, 1997: 280-281].

Ibn Taimiyyah regards land as the factor that enables production, so it can be employed for production, in the same way as money (capital). Therefore, he mentioned that *al-muzara'a* is a list of factors of production which are capital, labor and land, and all these components will produce crops [Islahi, 1988: 161].

Al-Sadr has argued that Islam confers upon the cultivator of the land a right to make use of it as his own rather than to anyone other than him. This can be recognized in that, according al-Sadr, the combination of land as well as the seeds and labor used in cultivating on it becomes property and therefore the Imam is allowed to levy tax on it for the total benefit of humankind [Al-Sadr, 1983: 135].

In parallel to al-Sadr, Taleqani also said that the capital is the product of the initial activity that went into the exploitation of the natural resources (land). Profits are generated as a result of

combining the primary and secondary activities while paying attention to differences in talents which give rise to differences in the value of the activity. In short, the owner of the capital (land) is the one who owns the resource or that which is derived from it [Taleqani, 1983: 144-145].

Moreover, these days most Islamic scholars in Egypt, including those from Azhar University¹ have stated and clarified that land can be considered as a capital. This is because land can produce output if appropriately combined with inputs such as labour, tools and seeds. Therefore, according to Islamic scholars in Egypt, rent or profit on land is only permitted when the owner of the land has put in his labor initially or works in partnership with other laborers.

In short, it can be said that land is similar to the capital of an *al-mudaraba*-partnership in which the owner of the capital advances his capital to a worker and shares with him the profit thus earned in the stipulated ratio of one half or one third etc. Although this profit is not known beforehand, for the capital owner does not know how much profit this venture will bring, yet this contract is legal. Therefore in a similar fashion the bare land of *al-muzara'a* and fruit trees of *al-musaqa* are all like the capital of *al-mudaraba*. Land can be regarded as a factor that enables production and, therefore, it can be employed or utilized for production in the same way as money.

2.2.4 *Al-Muzara'a* and *Al-Musaqa* as Form of Agricultural Product and Loss Sharing (aPLS)

The theory of *al-muzara'a* and *al-musaqa* is based on the transaction between the Prophet (pbuh) and the Khaybar tenants which mainly involved date palms forming the capital. Therefore, some Islamic jurists consider these principles as a partnership contract, wherein the capital provider advances his capital to the worker and the profit will be shared as stipulated earlier.

Additionally, these principles have transformed the use of land and labour into commodities which both give them a value and expose them to loss and damage. Hence, it can be said that land together with labor can be considered as a form of capital and therefore has a resemblance to the contracts of *al-mudaraba* and *al-musharaka*.

¹ Interviews with Islamic scholars from Azhar University, Cairo University and Alexandria University in Egypt were carried out during fieldwork from December 2009 until February 2010.

However, many researchers have made *al-muzara'a* and *al-musaqa* to be partnerships in profit just like *al-mudaraba*. Capital in *al-mudaraba*, by nature, will create profit and because of this it was known as profit and loss sharing (PLS) by many Islamic economists.

Nevertheless, *al-muzara'a* and *al-musaqa* has its classical form in classical custom. It was participation in output like sharecropping or output sharing. This is because the land as capital will produce the product or agricultural output.

Consequently, *al-muzara'a* and *al-musaqa* principles can be described as the contracts which are based on sharing the product or output rather than sharing the profit and should be recognized as agricultural product and loss sharing (aPLS).

In the meantime, Sarker (1999) opined that the principles of *al-muzara'a* and *al-musaqa* can be categorized as output sharing principles which means output or produce is shared between the parties in the contract. In the case of a bank, the bank provides the farmers with land, which is possessed by the bank itself, for cultivation on an output or crop sharing basis.

Kahf and Tariqullah (1992) also argued that land in a *al-muzara'a* and a *al-musaqa* contract is a fixed asset put at the disposal of the working partner. These arrangements ensure the use of assets without actually paying for them which is practically the same as financing. They also highlighted that both *al-muzara'a* and *al-musaqa* require sharing the gross output and allow for limited flexibility in the contractual distribution of operational expenses [Kahf and Tariqullah, 1992: 12].

Moreover, Khan, (1995) also argued that *al-muzara'a* and *al-musaqa* are known to be agricultural financing techniques and they are similar to *al-mudaraba*. The only difference is that, in *al-muzara'a* and *al-musaqa*, the output is shared and not the profit as in the case of *al-mudaraba* [Khan, 1995: 82].

Furthermore, Akhtar (1993) also suggesting that cooperative farming is an application of the ideal of brotherhood as a reflection to the Islamic ethos. Meanwhile, the jurists of Azhar University have listed the salient features of *al-muzara'a* and *al-musaqa* which can be described as a partnership between the landowner and the farmer as:

1. Sharing of the inputs of production
2. Sharing of the profit or loss
3. No predetermined amount of return
4. A partner relationship; not a debtor and a creditor relationship.

Based on the above argument, the principles of *al-muzara'a* and *al-musaqa* cannot be merely categorized as a similar to the scheme of Profit and Loss Sharing (PLS) based on the contracts of *al-mudaraba* and *al-musharaka* due to the difference in the nature of these contracts as PLS applies in trade while aPLS is more applicable in agriculture. This is can also be explained through the different types of capital in both schemes, money in PLS and land in aPLS that will shape the end of process of transaction, i.e. profit in PLS and agricultural output in aPLS.

Some Practices and Selected Researches on Partnership Contract in Agriculture

In terms of the practices of Islamic financial institutions towards Islamic agricultural financing based on the principles of *al-muzara'a* and *al-musaqa*, until recently, these forms of transaction have not been widely applied. This, nevertheless, is expected to change with the expansion of Islamic finance into micro credit and agricultural finance (Thomas *et. al*, 2005: 72).

In Pakistan, the State Bank of Pakistan has issued Guidelines on Islamic Financing for Agriculture (2009) to facilitate banks developing specific Sharia compliant instruments to apply among farming societies. These guidelines generally listed Islamic principles like *murabaha*, *ijara*, *musawamah*, *salam*, *istisna*, *musharaka*, *diminishing musharaka*, *mudaraba*, *muzara'a*, *musaqat*, and *mugharasa* that can be used for meeting the financing requirements of farming and non-farming activities including livestock, fisheries, poultry and orchards.

Kahf (1994) also claimed that the reason these contracts have not made serious headway among the modes employed by Islamic banks today may be because they require the financier to own land and equipment for a long period. It also, according to him, involves high risk especially in areas where agriculture depends heavily on rain and weather conditions.

In addition, there are prevailing arguments on inefficient partnership or sharing arrangements and partnership financing has been too risky for banks to adopt. However, sharecropping contracts as well as venture capital investment are extensively practiced as prominent forms of equity financing. Thus, even though Islamic banking theory emphasizes the importance of the partnership contract, further investigation is needed on its lack of popularity in practice. [Iqbal and Molyneux, 2005: 147-149].

3.1 “Inaccurate” Practices by Islamic Financial Institutions on Islamic Partnership Products for Agriculture.

Despite the marginalization of profit and loss sharing (PLS) financial products these days, there are also some practices based particularly on the *al-musahraka* contract for developing agricultural land, especially in Sudan and Iran. However, based on the arguments for PLS and

agricultural product and loss sharing (aPLS), it can be said that these practices are “inaccurate” in terms of the nature of Islamic jurisprudence contracts.

Al-Harran (1990) has found that farmers in Sudan have been working with Sudanese Islamic banks to finance their seed inputs through *al-musharaka* financing, whereby the farmer gets all his seed inputs from the bank through a partnership contract. Tamer, (2003) also mentioned that the *al-Musharaka* principle was utilized for diverse agricultural and industrial ventures in Sudan [Tamer, 2003: 72].

Furthermore, the Sudanese Islamic Bank (SIB) enters into a 3-party *al-musharaka* agreement with farmers under which the bank provides the working capital and the expertise. The working capital committed to an enterprise by a financier could be as specific as in the *al-muzara'a* requirement or it could be a multiple combination of modes as in the so-called comprehensive *al-musharaka*. Each party is remunerated according to the contribution they make to the scheme. The farmer is rewarded for his labor, the expert for his supervision and skill, and the bank for the working capital [Gulaid, 1995: 68].

In fact, the SIB also has experience in combining *al-musharaka* and *al-musaqa* into a single operation. In this scheme, the bank provides most of the agricultural input like seeds, fertilizer and part of the running expenses without collateral and/or guarantee. Farmers contribute with their land, labor, management, and part of the running expenses. In the meantime, The SIB has used the *al-musaqa* contract for irrigation processes on agricultural land. It undertakes the provision of irrigation pumps and accessories, installs them on the farm, and authorizes their operation by the farmer (Osman, 1999).

Khaleefa (1990) also highlighted the experience of the SIB in the implementation of Islamic banking procedures to the rural sector and to be more specific, the author pointed out the application of an *al-musharaka* contract in the agricultural sector as comparable with trade and industrial investment. The SIB started its participation in agricultural finance through *al-musharaka* as well as *al-murabaha* contracts in 1983 and it was extended in 1986 to cover a combination of the two in the Sudan.

In these partnerships, the SIB usually provides the agricultural inputs like seeds, fertilizers, machinery, working capital and irrigation services with the farmer commonly providing the arable land and labor for the agricultural operations or management. The net profit after deducting all operating costs and depreciation of fixed assets is divided between three partners;

30% for management (experts) and remaining profit shared between SIB and the farm owner on an equity share basis.

Yasserli (1999) claimed that the *al-musharaka* principle was as an all-embracing form of financing with wide-ranging applications in industry, agriculture, services, trade and housing in Iran. It was found, therefore, that the application of *al-musharaka* financing is regularly required to provide financing for long-term investment plans such as those found in the housing, manufacturing and agricultural sectors, particularly in agro-business projects.

Najmabadi (1999) has categorized the principles of *al-muzara'a* and *al-musaqa* as being applicable to the agricultural sector in Iran, as opposed to *al-mudaraba* which is specified for the commercial sector and *al-musharaka* which might be used in all economic sectors including agriculture, industry, housing, construction and trade.

Sadr (1999) argued that the performance of the Agricultural Bank (AB) of Iran has gradually increased and the role of *al-musharaka* financing has also significantly expanded for the provision of funds in the agricultural sector of Iran, to the degree that it became the major method of finance in 1996. This achievement has been stated in this article to be similar in nature to an *al-musharaka* contract with two parties involvement in the contract, which can be easily applied as a suitable alternative for equity financing in the agricultural sector. Another key point is the effective and continuous monitoring and supervision provided by the AB technical experts in order to cope with the problems of asymmetric information, moral hazards, and uncertainties.

3.2 Some Researches on the Partnership Contract in Agricultural Land

Nevertheless, in terms of researches on the partnership contract in agriculture, one of the most meticulous studies has been done by Donaldson (2000). Donaldson states that the contract of sharecropping resembles *al-muzara'a* and *al-musaqa*. In this research, Donaldson has made extensive analysis on the concept of sharecropping from economic studies and also from Islamic law perspectives. From the Islamic law side, Donaldson has discussed the concepts of *al-muzara'a*, *al-musaqa* and also *al-mugharasa*. He states the opinions of the Shafi'i school and also the Zaydi position on these contracts which were commonly practiced among Muslims in Yemen. Apart from this, Donaldson also discussed very well the methods of sharecropping practiced among Yemeni farmers.

According to Donaldson, whatever the theoretical legal positions on the contracts, it is maintained that *urf* (custom or customary law) directs community dealings rather than the Shari'a (the Islamic law) not only in South-West Arabia but also much more broadly in the Islamic world [Donaldson, 2000: 40].

Similar to Donaldson, Joseph (2005) also defined the contracts of *al-muzara'a* and *al-musaqa* as sharecropping between landlords and farmers based on Hanafi law. These principles have given rise to debates among Hanafi scholars in terms of their legality. While Imam Abu Hanifah disapproved of these principles, Hanafi muftis and legal thinkers in Syria established conditions to make these contracts legal.

Joseph also stated that each partner in a sharecropping contract was entitled to a share of the product based on the elements of production contributed by each, and also by the terms and legality of the contract itself. In Islamic law, the sharecropping contract is governed by two important limitations; the land must be well suited for the growing of crops and there must be no trees or plants/crops already grown on the land.

Furthermore, Haque (1985) has done a holistic theoretical study on the contract of *al-muzara'a* and *al-musaqa*. This research covered the Hadith perspectives on the *al-muzara'a* contract as well as the development of the substantive law of this contract by classical Islamic jurists like Imam Abu Hanifah, Imam Malik, Imam Shafi'e, Imam Ahmad ibn Hanbal, Abu Yusuf, Ibn Hazm and Ibn Taimiyya.

Therefore, it can be concluded that the principles of *al-muzara'a* and *al-musaqa* are closer to the concept of sharecropping than *al-mudaraba* and *al-musharaka*. However, several researchers have likened the *al-mudaraba* contract to the concept of sharecropping in economics as well as to the concept of Profit and Loss Sharing (PLS). This is can be considered "erroneous" by using the above mentioned arguments.

For instance, Dar, (1996) claimed that the sharecropping and the PLS are similar contracts and involve an agency problem between contracting parties. He also mentioned that sharecropping in agriculture and PLS in the financial sector involves similar contracts between individuals with insufficient resources to carry out production activity. A basic reason for the existence of such contracts is that contracting parties have insufficient resources to conduct the production process independently.

Furthermore, Madi (1989) also suggested that Islamic banks may employ a set of basic types of Islamic contracts based on *al-mudaraba*, *al-musharaka* and *al-murabaha* in order to finance various economic activities such as trade, industry, agriculture and commerce. He stated that an Islamic partnership based on *al-mudaraba* and *al-musharaka* is legal and practical to offer as the foundation for participation in agriculture. This can be considered as a “misleading suggestion” because Islamic partnership financing for agriculture is more suited to the principles of *al-muzara’a* and *al-musaqa*.

In addition, Khan (1983) also argued that PLS is a financial mechanism channeling finance capital to industry and commerce without the exercise of interest. He also criticized that sharecropping can lead to *riba* because mere ownership on the part of the landowner guarantees a return as well as including an element of uncertainty (*gharar*). Therefore, the application of PLS based on *al-mudaraba* as a tenure arrangement among farmers and landlords is necessary.

Moreover, Kahf and Khan (1992) have classified the contract of *al-mudaraba* as applicable as a financing tool for industrial production and *al-muzara’a* as output sharing based financing in the agricultural sector. However, the authors still highlighted the PLS scheme based on *al-mudaraba* and *al-musharaka* in the application of Islamic methods of financing in agriculture particularly in the marketing of agricultural output.

Ismail and Karmila (2009) also stated that the contract of *al-musharaka* can be applied in the agriculture, forestry and fisheries sector mostly for storage and other farm construction such as cattle sheds and fencing.

3. The Proposed Scheme of aPLS for the Islamic Finance of Agriculture

It is a fact that the expansion and modernization of agriculture requires capital injections that normally far exceed the amount that farmers are able to save. Funds are needed to finance infrastructure projects including the purchase of seeds and machinery, irrigation, drainage, improved inputs and so on (Elhiraika, 2003: 7).

In Islamic banking systems, banks are considered as organizations working with their customers’ funds. In general, Islamic banks offer two kinds of banking facilities; firstly, debt financing or fixed profit facilities like hire purchase, an installment sale at a fixed rate of profit which is based

on principles of *al-murabaha* and *al-bay bithaman ajil* and secondly, partnership financing or variable profit facilities, based on profit and loss sharing rooted in *al-musharaka* and *al-mudaraba* principles.

From the classical point of view, Abu Yusuf and Shaybani listed the types of *al-muzara'a* contract which were valid and resembled a partnership contract or what is known as agricultural product and loss sharing (aPLS) that might be proposed in current situations. First, the land, implements (machines), seeds and animals are provided by the landowner and the work (effort) is undertaken by the tenant. Second, the land is provided by the landowner and the rest is provided by the tenant. Third, the land and seed is from landlord and the rest from the tenant. However, if the land and implements (machines) are provided by the landowner and tenant provides the seeds and the work, this type of contract is considered invalid (Kasani, 1968: 3816-3819).

Basically, a financing arrangement based on *al-muzar'a* and *al-musaqa* or aPLS contract can be initiated subject to a joint partnership in the mobilization of land, other physical inputs and labor.

For instance, Gulaid (1995: 46) has classified how *al-muzara'a* can take various forms in financing. To begin with, a contract based on this principle might specify that the land and other physical factors of production for the partnership could come from one party while the labour could be supplied by the other party.

On the other hand, only the land might originate from one party while the other factors, including labor, could come from the other party in the contract. Yet, another alternative of *al-muzara'a* is that both the land and labour could come from one of the contracting parties, while all the other factors of production might be provided by the other party in the contract. Incidences of a three-party *al-muzara'a* 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.

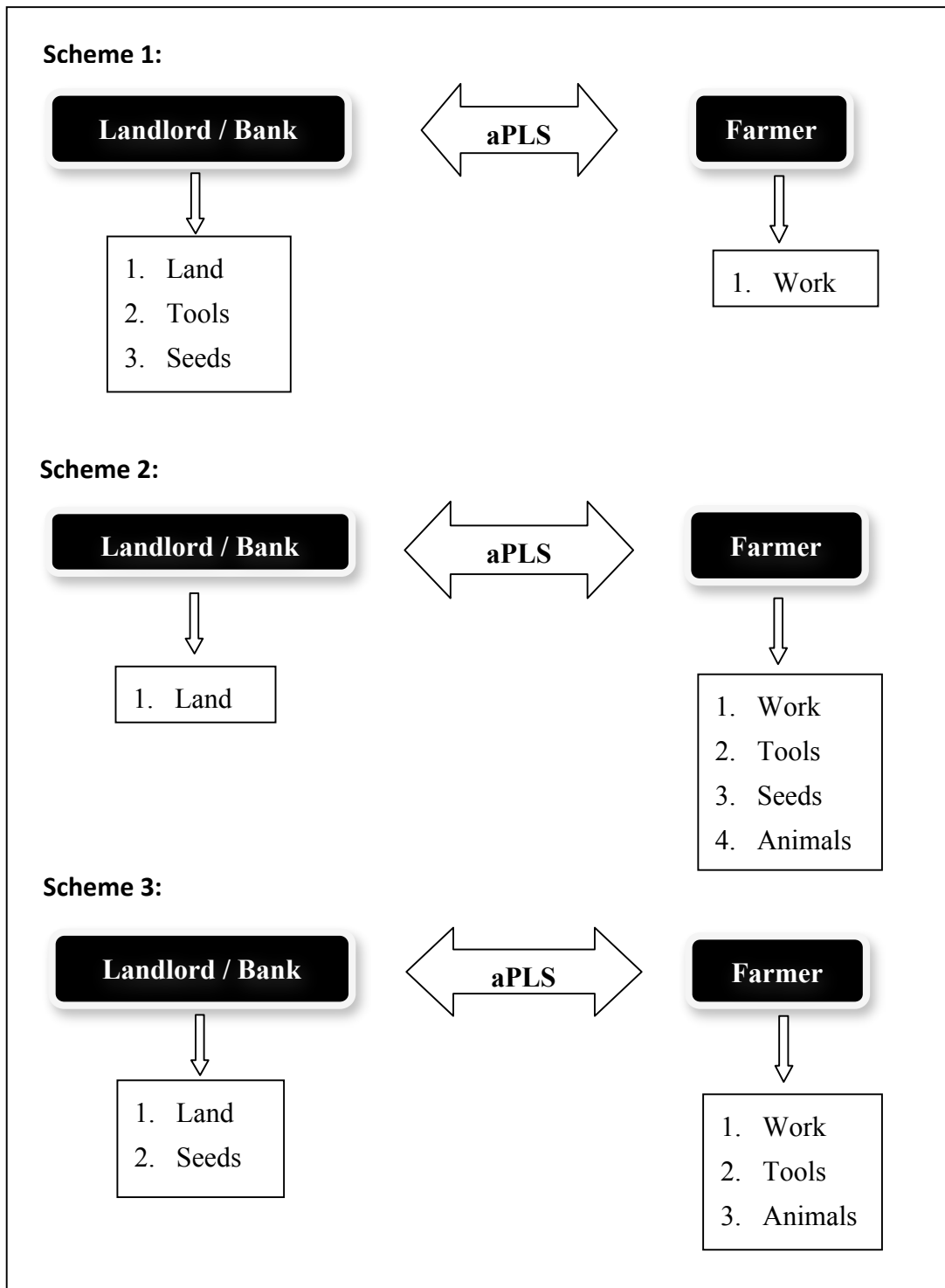
Therefore, in this paper, using the forms of contract suggested by Abu Yusuf, the three schemes of aPLS as shown in Figure 1 below are suggested here. First, the land, tools, seeds and animals are provided by the landowner and the work (effort) is undertaken by the tenant. Second, the land is provided by the landowner and the rest is provided by the tenant. Third, the land and seed is from landlord and the rest from the tenant.

From the banks' perspective, the schemes of *muzara'a* and *musafa* can be applied to the financing of agricultural inputs for a specified period of time. In the basic context, the bank will provide funds for the agricultural investments, meanwhile the labour is provided by the farmer. Therefore, in this context, *muzara'a* and *musafa* contracts can be used for obtaining seeds, fertilizers and pesticides along with the needs for the irrigation, storage and marketing of the agricultural commodities.

Alternatively, there is also a possibility for the bank to be a landlord. The bank could first buy the land and then give it to the potential farmer to cultivate according to the aPLS principle. In this case, an Islamic bank plays the role of landowner directly and has a partnership with the farmers.

However, these suggestions will need not only to employ the principles of *al-muzara'a* and *al-musafa* themselves, but will also involve some other principles like *al-ijarah al-muntahia bi-tamlik*, *al-murabahah* and *bay al-salam*. Currently, the Islamic banking institutions are not implementing only one-sided *al-mudaraba* as in classical theory, but incline more to two-tiered *al-mudaraba*. The banks accumulate deposits from their customers and invest them with third parties based on this principle. Hence, it is relevant to use the principles of *al-muzara'a* and *al-musafa* with proper adjustments from financial experts to make them practical transactions in Islamic banking and financial institutions. Therefore, defining particular steps would require input from many parties, both academicians and practitioners.

Figure 1: The Proposed Schemes of “Agricultural Products and Loss Sharing” (aPLS) between Landlord / Bank and Farmer



Conclusion

In general, *al-muzara'a* and *al-musaqa* contracts can be defined as an agreement between the owner and the farmer of a piece of land. They would share the produce in proportions which are agreed and depend on the contribution that each has made. In practice, one of the partners is working on the agricultural project and other is providing capital (land). The relationship between the partners is based on mutual trust, with the landlord having relied heavily on the farmer's ability to manage and his honesty when it comes to harvesting.

Specifically, *al-muzara'a* is for the cultivation of general agricultural products as *musaqa* is for orchards. The approach crosses into a form of partnership or product and loss sharing in agriculture. These principles have transformed the use of land and labour into commodities which both give them a value and expose them to loss and damage. Hence, it can be said that land together with labour can be considered as a form of capital and therefore this has a resemblance to the contracts of *al-mudaraba* and *al-musharaka*.

However, the similarity of *al-muzara'a* and *al-musaqa* to *al-mudaraba* and *al-musharaka* is not in the substance of the contract. This is because the *al-muzara'a* contract focuses on agriculture, while *al-mudaraba* is more suited to trade contracts and industrial or commercial operations. Therefore, *al-muzara'a* and *al-musaqa* can be identified as "production and loss sharing in agriculture" (aPLS) and *al-mudaraba* as "profit and loss sharing"(PLS).

Consequently, *al-muzara'a* and *al-musaqa* principles can be defined as contracts which are based on sharing the product or output rather than sharing the profit and should therefore be recognized as agricultural product and loss sharing (aPLS).

In short, an Islamic partnership contract by the financial institutions for agricultural land development should be by the implementation of aPLS which is based on the principles of *al-muzara'a* and *al-musaqa* and not profit and loss sharing (PLS) which is based on *al-mudaraba* and *al-musharaka*. This is fundamental because an understanding of the nature of Islamic jurisprudence as a whole will lead to creating practical Islamic financial products which can meet the expectations of the people.

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