ISLAMIC BUSINESS CONTRACTS, AGENCY PROBLEM AND THE THEORY OF THE ISLAMIC FIRM

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A contract for business organization or production process may generally involve principal-agent problems due to information asymmetry. This paper discusses some important norms of Islamic business ethics; undertakes an anatomy of classical Islamic contracts and argues if an Islamic firm implements the business contracts as designed and approved by the Shariah, then principal-agent problems could be minimized.

Introduction

The title of the essay encompasses three aspects of Islamic economics and banking which are inter-related. Islamic business contract basically is based on the fiqhi discussions enumerated by the different schools of thought or madhab. Of which, Mudaraba or Agency is regarded as the most important tools which involves two or more parties entering into a contract with capital and entrepreneurship to undertake a joint venture (trade, business, manufacturing etc.) to share the profit according to a pre-determined ratio. The third issue, under analysis is, however, the nature, significance and the modality of the theory of the Islamic Firm. Therefore, an attempt has been made in this essay to explain the above three aspects in brief.

The essay is organised as follows . **Section I** describes the basic shariah principles or fiqh-al-muamalat of the Islamic business contracts, definitions, nature and different classification of the contracts and their comparative economic features. **Section II** exclusively deals with the Agency problem, its Nature, Characteristics and Relevance With the Islamic Modes of Contracts. The genesis of the theories of the firm on competence-based, evolutionary and reward-sharing are examined in **Section III**. **Section IV** provides the nature and characteristics of the Islamic theory of the firm. Finally, **Section V** summarises the conclusions.

1. Basic Shariah Principles or Fiqh-al-Muamalat of the Islamic Business Contracts

Broad-based economic well-being, social and economic justice, and equitable distribution of income and wealth is the primary objective of Islamic economics. The intense commitment of Islam to brotherhood and justice makes the well-being or 'falah' of all human beings the principal goal of Islam. To achieve falah, Islamic economics and banking has developed different Islamic investment products.

1.1 Forbidden Elements in Contract

Among the most important teachings of Islam for establishing justice and eliminating exploitation in business transactions is the prohibition of all sources of unjustified enrichment. Three aspects of forbidden elements in contracts which may induce people for unjustified enrichment are : Riba, Gharar and Maysir.

(a) Riba or Interest

Riba or interest is completely prohibited under Islamic law. Riba is a prominent source of unjustified advantage, because Shariah does not consider money as a commodity such that there should be a price for its use. Money is a medium of exchange in an asset oriented economy, and a store of value. However, the term riba or interest is used in the Shariah in two senses, riba-an-nasiah and riba-al-fadl. Riba-an-nasiah refers to the time allowed to the borrower to repay the loan in return for addition (financial increment) (nasiah is related to the verb nasa'a, meaning to postpone, defer or wait). It makes no difference whether the return is a fixed or a variable percentage of the principal, an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition

for the loan. This leaves no room for arguing that riba refers to usury and not interest. Riba-al-fadl, on the otherhand, is related with the transactions of the homogeneous goods. Riba-al-fadl arises if gold, silver, wheat, barley, dates and salt are exchanged against themselves with unequal proportion. That is, they should be exchanged on the spot and be equal and alike, otherwise any change in transactions will create riba-al-fadl. However, the absolute prohibition of riba or interest in the Quran and Hadith is a command to establish an economic system from which all forms of exploitation are eliminated, in particular, the injustice of the financier being assured of a positive return without doing any work or sharing in the risk, while the entrepreneur, in spite of his management and hard work, is not assured of such a positive return. The prohibition of interest is, therefore, a way to establish justice between the financier and entrepreneur.

(b) Gharar or Dubiousness in Contract :

The Shariah determined that in the interest of fair and transparent dealing in the contracts between the parties, any unjustified enrichment arises out of uncertainty or undefined of the essential pillars of contract is prohibited. Gharar is originated out of deception through ignorance by one or more parties to a contract. Gambling is also a form of gharar because the gambler is ignorant of the result of the gamble. There are several types of gharar, all of which are haram. The following are some examples:

i. Selling goods that the seller is unable to deliver ;

ii. Selling known or unknown goods against an unknown price, such as selling the contents of a sealed box ;

iii. Selling goods without proper description, such as shop owner selling clothes with unspecified sizes;

iv. Selling goods without specifying the price, such as selling at the 'going price' ;

v. Making a contract conditional on an unknown event, such as when my friend arrives if the time is not specified ;

vi. Selling goods on the basis of false description ; and

vii. Selling goods without allowing the buyer to properly examine the goods.

In order to avoid gharar, the contracting parties must (i) ascertain that both the subject and prices of the sale exist, and are able to be delivered ; (ii) specify the characteristics and amounts of the counter values ; (iii) define the quantity, quality and date of future delivery, if any.

(c) Maysir or Gambling

The prohibition of maysir arises from the premise that an apparent agreement between the parties is in actually the result of immoral inducement provided by false hopes in the parties mind that they will profit unduly by the contract.

The Nature of the Forbidden Contracts

A number of barter arrangements peculiar to pre-Islamic market trading was expressly forbidden by the Prophet Muhammad (salla-llahu alaihi wa sallam). The characteristic they have in common is that they depend on conjectured or uncertain definition of the goods being traded. It is from the explicit prohibition of such barter arrangements that Islamic law developed its strict rules about definition of the objects (and terms) of contract. Examples of forbidden contracts are :

Muzabana : The exchange of fresh fruits for dry such that the quantity of the dry fruit is measured and fixed but the quantity of the fresh to be given in exchange is estimated while still on the trees.

Muhaqalah : The sale of grains still growing (that is, unharvested) in exchange for an equal quantity of harvested grains. (The prohibition of this particular transaction is an important element in the general discussion of gharar (uncertainty), the basis of the prohibition of futures trading in grain and other foodstuff and stock commodities).

Mulamasah : An historic sales contract in which the sale was finalised with the buyer or seller touching a piece of cloth.

Munabudhah : An historic sales contract in which the sale was finalised with the buyer or seller throwing a piece of cloth towards the other.

1.2 Basic Shariah Principles of Business Contracts

While the nature of all the forms of business contracts are different from each other, the basic principles of the Shariah with regard to them are almost similar. These basic principles are as follows :

(1) 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.

(2) Business capital should be in the form of money. If any or some of the partners are joining with their running business or commodity or property the value of their business, commodity or property should be determined in terms of money and this amount should be treated as the partners' contribution.

(3) In a partnership the relationship between the partners is that of a principal and agent. In joint stock companies the shareholders are only the co-owners without enjoying agency rights.

(4) Capital and labour and in some cases goodwill and credit-worthiness are jointly responsible for creating profits and are jointly responsible to a share in the profits. In case only one single factor is responsible for creating profits it will solely be eligible to it.

(5) The rights and duties of the partners depend on the nature of the joint business and are largely governed by the custom, convention and usage. In this respect the interest of the business is the most important criterion of determining the rights and duties of the partners.

(6) Rights are concomitant to responsibilities. Thus a dormant partner may be disallowed to bind the firm by his commitments. The partners would not claim any fixed return for their work except a share in profits, but the employees would receive their wages from the business account.

(7) In a joint business, productivity and profit are measured on the basis of invested capital. But it is labour that contributes to productivity and profit. Thus the proportion of partners respective shares in capital alone cannot be a factor of determining the respective shares of the partners in the profits of the business. The proportion of profits cannot, therefore, necessarily be commensurate with the share in capital. The partner with a higher contribution of labour may be allowed a higher share in profits although his capital contribution may be lesser than others.

(8) Loss is incurred in case capital fails to grow and diminishes. Thus in the event of a loss non-payment of profits to working partners amounts to loss of labour. Loss in capital is exclusively to be borne by capital. In this way while the profit may be distributed according to the stipulated condition loss is to be borne by partners proportionately with their respective shares in business capital.

(9) The basic principle is that profits go with liability. Thus a partner who is ready to bear a liability would share in profits also. Persons joining the business to take a share only in profits without contributing anything to business and without accepting any liability are not eligible to profits as a matter of right.

(10) Profits are concomitant to risk. No partner has a right to set apart a fixed portion of profits, thus ensuring for himself a sure return. If profits arise all partners would share in it proportionately. If there are no profits no partner would be privileged to take any share by way of his exclusive right.

(11) Loss arising out of wilful negligence would be indemnified by the partner who is responsible for it.

(12) The liability of the partners would depend on the nature of the joint venture.

1.3 Definition, Nature and Different Classification of the Islamic Business Contracts

The legal form of an Islamic business enterprise or contracts sheds light on how capital is raised, how labour is employed, how factors are remunerated, who makes decisions, how much enterprises or contracts are dissolved, and who bears the risks of failure. Those types of business contracts and organisations that were in use before and during the time of the Prophet Muhammad (sallahu alaihi wa sallam) and that he did not prohibit, are accepted as legal forms of Islamic enterprises or contracts. Therefore, the Islamic Shariah provides various modes of finance or business contracts each of which has its own distinctive features and utilisation modalities.

Islamic business contracts can be classified into three broad categories :

1. Business contracts on the basis of **Direct Financial Accommodation or Uqud al-Ishtirak** : Profit Sharing Principle, Profit Loss Sharing Principle, and Output Sharing Principle.

2. Business contracts on the basis of **Indirect Financial Accommodation or Uqud al-Muawadhat** : Mark-up based Principle, Lease based Principle, and Advance Purchase Principle.

3. Other forms of permissible contracts are : Direct Investment, Finance on Development Charge, Rent-sharing on the basis of construction/purchase of houses/flats, godowns, sheds etc. on co-ownership basis, Investment Auctioning, Syndication and Consortium Financing.

Direct Financial Accommodation

Profit Sharing Principle :

Mudaraba (short term) : Profit sharing principle for Islamic business contracts is based on the Mudaraba principle in which the owner of the capital provides funds to the capital-user or entrepreneur for some business or productive activity on the condition that profits generated will be shared between them. The loss, if any, incurred in the normal process or course of business and not due to neglect or misconduct on the part of the entrepreneur is borne by the capital-owner. The entrepreneur does not invest anything in the business except his human capital and does not claim any wage for conducting the business. The ratio in which the profits are distributed is ex-ante. In the event of loss , the capital provider loses his capital to the extent of his loss, and entrepreneur losses all his labour. The willingness to bear the loss justifies a share in the profit for the capital-owner. The profit sharing ratio mutually agreed upon between finance-provider and finance-user is determined by the market forces (Siddiqui, 1987). The finance-user guarantees to return funds only on two conditions : (a) if he negligent in the use of the funds or if he breaches the conditions of mudarabah (Iqbal and Mirakhor, 1987). Regarding loss in the mudaraba form of business contract, Ibn Qudama opined that..... 'if, however, the loss is a result of a misuse or a violation of the conditions of the contract on the part of the working partner, then he alone will be liable to cover it' (see, Ibn Qudama, Al Moghni—5/49).

Classification or Types of Mudaraba :

There are two main types of mudaraba : Restricted and unrestricted mudaraba.

(a) Restricted Mudaraba : In this type, the capital owner asks the working partner to trade by his capital subject to certain restrictions related to the type of commodity that is to be traded, the time of trade, the place of trading or the person with whom the working partner should trade. The restrictions related to time or persons are approved in both the Hanbali and Hanafi Schools but not approved in Shafi and Maliki Schools.

(b) Unrestricted Mudaraba : In this case, the working partner or mudarib can trade in any commodity (that is legitimate), with any persons which he deems appropriate without being restricted to certain period of time or place.

Other Forms of Mudaraba Contract :

1. Mudaraba Mutlaq : Non-contractual mudaraba and **Mudaraba Muqaiadah** : contractual mudaraba

2. Single Mudaraba : Where one Mudarib and one provider of funds take part in the contract and **Compound Mudaraba** : Where a number of Mudarib and a number of providers of funds, or a multiplicity of mudarib and one provider of funds, or a multiplicity of providers of funds and one mudarib take part in the contract.

3. Limited Term Mudaraba : In this type of mudaraba, profits are accounted for at the time the work is liquidated, and in case of **Continuous Mudaraba**, profits are accounted for on a periodical basis during the mudaraba period.

4. Commingled Mudaraba : Mudaraba funds are invested by both parties to the contract while the work is carried out by the mudarib alone, and in **Non-commingled Mudaraba**, mudaraba funds are invested by the provider of funds only.

Conditions of Mudaraba

There are certain conditions related to the mudaraba contract, the most of which are described as follows :

i. Conditions related to the eligibility of the partners : The legal position of the working partner or manager in the mudaraba contract differs according to the actual stage of activity. Before the activity starts, he is considered as a trustee on the capital of the owner. After activity starts, he is considered as a proxy for the owner of the capital. When the outcome of the activity appears, then the two parties(working partner and owner of capital) are partners. This fact necessitates the eligibility of the two partners to act as an attorney or to depute others for same tasks.

ii. Conditions for the capital : The same conditions stipulated for musharaka apply also for the mudaraba contract. Capital should be liquid money and cannot be in the form of other assets. The capital should also be designated by quantity and must be well-defined by type and quality. It cannot be unforeseen or in the form of debt which is due on the working partner to the owner of capital. The capital should also be delivered to the working partner in full to enable him to trade or engage in production freely with it. This condition is imposed by the majority of schools(Shafi, Maliki and Hanafi). However the Hanbali school differs in its opinion and approves even a partial delivery of capital to the working partner.

iii. Conditions related to the distribution of profits : Method of distributing profits between partners should be clearly defined and declared in the contract on a percentage basis. If, however, the contract stipulates that profit will be distributed on a participatory basis between the two partners without mentioning the percentage, then the contract is valid and profits are distributed on a 50% basis for each of them. If there is any ambiguity with regard to the distribution of profits, then, the contract will be considered as nullified. Also, it is to be noted that profits stand as a guarantee for capital. This means that if the activity results in profits, then the working partner is not allowed to take any part of it except after refunding the total amount of the principal capital to the owner. Any further profits could be distributed between the two partners according to the declared percentage.

iv. General rules related to the legitimate mudaraba : There are some transactions and activities that the working partner is not allowed to perform unless he obtains a clear approval or permission from the capital owner. Examples of such activities are as follows :

a) to establish a new company or a new mudaraba with others ;

b) to deposit the capital of the mudaraba with others ;

c) to mix the capital of the mudaraba with his own money before he starts the activity ;

d) to sell or trade with others on deferred or instalment basis ; and

e) to travel with the capital to other places.

If working partner makes any of the above activities without obtaining the permission of the capital owner, then he will be liable for any losses that may inflict capital. The capital owner may, however, permit the working partner to carry out one or more of these activities, or he may also depute him to take charge of all of them by saying to him : "act according to your opinion". In such a case the working partner will not be liable for any losses that may occur, provided that he does not deliberately violate any stipulation of the contract.

v) Cancellation of the mudaraba contract : The majority of the Shariah scholars are of the opinion that the mudarabah contract is revocable, therefore, it could be cancelled by any of the two partners at any time. Capital should be liquidated in this case in order to identify the profits or losses and profit, if any, must be distributed among the partners.

Profit and Loss Sharing Principle : Musharaka (long-term)

Musharaka (company or partnership contract) is a form of business organisation where two or more persons contribute to the financing as well as the management of the business, in equal or unequal proportions. Profits may be divided in any (but not necessarily be equal) ratio agreed upon between the partners because the two parties may share the work of managing the business or project in any amount mutually agreed upon. Both parties are allowed to charge a fee or wage for any management or other labour put into the project(Khan, 1987). All providers of capital are entitled to participate to management but are not necessarily required to do so. The losses, however, will be shared in the exact proportion of the capital invested by each party.

it is to be noted, however, that although all Shariah scholars were on the general consensus that the Musharaka as a principle is legitimate from the point of view of Shariah, they differ in their opinions with regard to the legitimacy of the different types of musharakas.

Classification or Types of Musharaka

Musharaka or Profit Loss Sharing may be classified primarily as two broad heads namely : Shirkat-al-Melk or non-contractual musharaka and Shirkat-al-Uqud or contractual musharaka.

Shirkat-al-Melk

Shirkat-al-Melk is divided into two parts :

(a) Shirkat-al-Melk Bil Ekhtiar or voluntary partnership ; and

(b) Shirkat-al-Melk Bil Zabir or involuntary partnership.

Shirkat-al-Uqud

Shirkat-al-Uqud is also divided into some parts. The following are prominent :

(a) Shirkat-al-Inan : Unequal partnership contracts where any party can participate with any proportion.

(b) Shirkat-al-Mufawadah : Equal partnership contracts where capital, profit and loss are shared equally.

(c) Shirkat-al-Wujuh : Goodwill-based partnership or credit partnership where business is conducted on the basis of goodwill and goods and commodities are hired on credit.

(d) Shirkat-al-Abdan : This is a form of general partnership business. This partnership is formed on the basis of labour, skill and management. This is also called Shirkat-as-Sanai(partnership in crafts or art), Shirkat-al-Amal(on the basis of work) and Shirkat-at-Taqabbul(partnership in contracting).

(e) Permanent Musharaka or Continued Musharaka where all parties in business contract are engaged continuously in the business.

(f) Digressive or Diminishing Musharaka or Al-Musharaka al-Mutanakissa or Al-Musharaka at-Tanazoleya where one of the two partners or any partner in the contract can withdraw gradually from the project or business by selling part of its share to the other partner. As in the case of a bank, the share of the bank in the profits shall also diminish with the same proportion by which its share in the capital is reduced, while the share of the other partner(here the customer) in both the project and the realised profits will increase at the same time.

(g) Civil Partnership and Legal Partnership : Partnership in Iran has been classified into these two forms : civil and legal. In the former, bank acts one of the co-financiars and in the latter, bank's fund are not treated as in the general pool. It can sell it out its share whenever it likes.

Output Sharing Principle :

In this type of contracts, output or produce is shared between the parties in contract. Output sharing contracts are mainly of two types namely, Muzara'a and Musaqat.

Muzara'a : It is a contract between an owner of a piece of agricultural land and a farmer for farming it in return of a percentage of its crop. In case of bank, bank provides farmers land (to which is possessed by the bank itself) for cultivation on crop sharing.

Musaqat : This is one of the variant of Muzara'a. In this case, bank provide farmers orchards, gardens or trees (which is possessed by bank) for harvesting on crop sharing.

(II) <u>Indirect Financial Accommodation</u>

1. Mark-up based Principle or Murabaha :

This is a cost plus contract in which one party wishing to purchase equipment or goods and commodities approaches other party to purchase those items and sell to him at cost plus a declared profit. By this method of contract, a party needing finance to purchase business machinery or equipment gets the necessary finance on deferred payment basis. Farmers may also get various inputs and agricultural implements from the bank on a deferred payment basis.

2. Lease-based Principle or Ijara :

An individual short of funds may approach another with a surplus (the other party or financier) to fund the purchase of a productive asset and renting that to him on rent-payment basis. If the title of the asset is fully transferred to the user at the end of the period, i.e., lessee become the owner of the asset, then it will be called Hire Purchase or Ijara wa Iqtana.

3. Advance Purchase Principle :

Bai-Salam : The term Bai-Salam means advance payment or forward buying. The salam contract is the sale of a good to be delivered to the purchaser at a future date, which is set at the time of the contract. This is a trade transaction contract and not a loan contract. This type of financing is most often used when a manufacturer needs capital to manufacture a final product for the buyer. In return for paying in advance, the buyer receives a more favourable price (i.e. splits the profit margin with the manufacturer).

Istisnaa (Progressive Financing) : A contract of acquisition of goods by specification or order where the price is paid progressively in accordance with the progress of a job. An example would be for the purchase of a house to be constructed, payments are made to the developer or builder according to the stage of work completed. Istisna contract opens the way to a number of new possibilities of business contracts including some forms of futures contract trading of processed commodities, as it permits deferring of both ends of the contract : delivery as well as payment.

1.3 Comparative Economic Features of Islamic Business Contracts

The comparison of the distinctive features of the above individual business contracts is summarised in the following

i. According to nature of financing, Bai-Salam and Murabaha(mark-up) can be regarded as debt-based modes of contract because the finance-user is obliged to pay back the entire financing while in mudaraba and musharaka the finance-user pays according to the profit/loss that he makes out of the use of financing.

ii. In mudaraba and bai-salam the financier has no role in the management of the funds. In the case of Murabaha and Ijara, the financier has full control over the use of the funds.

iii. In mudaraba, the owner of the capital is responsible for bearing all the financial loss of the business and in musharaka he will bear the financial loss in proportion to his capital in the total investment in business. So, their capital shares are at stake until the completion of the term of business. But, in mark-up based financing, risk is minimal for the capital invested, only upto the stage of handover of goods or commodities to the client and after that financier does not share any risk until recovery. In some countries, like Bangladesh and Pakistan, a penalty provision is introduced on mark-up based contracts if the stipulated instalments are not paid by the clients to the bank in due time-period which also acts as a risk minimiser. This type of mark-up on mark-up is called "compensation charge" in Bangladesh and "kheyanat charge" in Pakistan respectively.

iv. In mudaraba and musharaka, uncertainty of the rate of return on capital is very high due to asymmetric information which creates moral hazard and adverse selection problem. On the otherhand, rate of return is fixed and pre-determined in other modes of contracts.

2. Agency Problems, Its Nature, Characteristics and Relevance With the Islamic Modes of Contracts

2.1 Agency Problems

By the word 'Agency' we mean that conductive mechanism by which production firm or business enterprises are managed or conducted. Basically, the agency function is related and governed by the modalities of the contracts. Agency costs is a factor under each type of contracts. The divergence of interests and asymmetry of information between principal and agent may cause output to depend upon the contingent nature of the compensation contract. Different theories of agency show that correlation between remuneration and productivity determines the growth of the enterprises and behaviour of the agency. However, the realisation that 'Arrow-Debreu ideal' or 'more-less frictionless world of complete information, perfect foresight and castles transacting' is insufficient to accommodate a number of important economic phenomena has led the economists to focus on 'the process of contracting' — particularly its hazards and imperfections.

2.2 Classification and Characteristics of Agency

Contracts specify the rights and obligations of the parties in various future states of the world, supply incentives for the efficient sharing of risk and information. Principal-agent models analyse situations in which information is unevenly or 'asymmetrically' distributed between contracting parties with potentially divergent interests. The most commonly analysed relationships are those in which one party acts on the other's behalf, as is assumed to be the case in employment, agency or franchise agreements. Adverse selection, prior to the contract and moral hazard, during its performance, arise where the "principal" can not costlessly observe or monitor the agent's characteristics and/or actions. Therefore, the issue arises how the principal can induce the agent to act in such a way as to maximise the principal's utility.

The above situation has led to develop different theories or structure of contracts such as 'piece-work contracts' or 'share-cropping contracts'(in the context of post-Coasian, neo-classical accounts of the theory of the firm), uneven distribution of risk in the contract, 'complete contract' which specifies the rights and obligations in all relevant future states of the world—which can be costlessly enforced and need to be negotiated, 'incomplete contract' which will be silent about the parties obligations in some states of the world and will specify these

obligations only coarsely or ambiguously in other states of the world (Hart, 1995 : 23). However, there are many issues concerning contract form and duration, on the one hand, and the relationship between private ordering and the rules of contract law, on the other remain far from clear.

Game theory, which studies the 'strategic' behaviour of an economic agent in response to the anticipated moves of others, has come to play a growing role in the analysis of these issues. The success of strategies for future co-operation between contracting parties depends on how far each one calculates that it is in his or her self-interest not to breach or 'defect' from the arrangement, given the likely behaviour and response of the other. The 'Nash equilibrium' describes a situation in which each party adopts and maintains a strategy which will maximise its own interest, given the choice or strategy of the other(s).

It is seen from the above views on the contracts that contracts provides the framework for a complex set of interactions between the parties to economic relationships. Agency problem is an important determinant of reward-sharing in a production process which may be solved through efficiency attained in allocation of resources and putting a package of incentives in reward-sharing structure.

2.3 Implications of Agency Problem in Islamic Contracts

From the perspective of the corporate finance literature, the obvious advantage of Islamic banking is its greater ability to allocate risk optimally through the sharing of project returns between owner of the capital and entrepreneur. 'Despite this positive risk-sharing benefits, Islamic or PLS banking also faces severe principal-agent problems arising from asymmetric information and costly monitoring.

Firstly, such a bank would face difficulties resulting from ex-ante information limitations concerning project quality. Borrowers have inside information about their personal activities and projects' likelihood of success that cannot be credibly signalled to the bank because every PLS applicant will claim to be of the highest quality. The banks' difficulty in determining the quality of loan applicants produces various adverse selection problems—especially when debt finance is available from competing sources'. (Mills and Presley, 1998). Those borrowers who expect their projects to supply high non-monetary benefits but low realised profits will choose PLS financing because they will enjoy high total returns at an artificially low cost of capital (Pryor, 1985). Similarly, PLS banks will attract applications with inside knowledge that their project is highly risky, and borrowers who will inflate their declared profit expectations in the hope of being quoted a lower profit-sharing ratio by the bank (Nienhaus, 1983).

Secondly, in PLS contracts, borrowers have the every incentive to under-report or artificially reduce declared profit. They can deflate profit by taking excessive perquisites or extra leisure or resorting to accounting subterfuges. Therefore, Islamic banks would have to incur costly monitoring expenses to ascertain whether declared profit is true reflection of the activities or business enterprises/projects or not. This ex-post information asymmetry leads Islamic banks to a moral hazard problem.

Thirdly, an Islamic bank's susceptibility to moral hazard and adverse selection would probably make it uncompetitive with conventional rivals, because of the additional dead-weight costs in information-gathering and project appraisal, reduced work incentives for entrepreneurs and higher production costs (e.g. Goodhart. 1987).

2.4 Solutions to Overcome the Agency Problems in Islamic Banking

(1) To incorporate ignored behavioural consideration in the contract, principal-agent problem can be solved in the PLS banking system. Because, reward attached to co-operation might induce the agent to behave honestly.

(2) Some researchers argue that, for two reasons the principal-agent problem will be at a minimum magnitude in an Islamic economy. Firstly, Muslims believe in the eternal concept of life, in which honesty is rewardable and dishonesty punishable. This is a non-material incentive for people to be honest. Secondly, if all financial operations are based on sharing (and a continuing rather than one time relationship is developed between financiers and entrepreneurs), honest entrepreneurs will force dishonest entrepreneurs out of the market. So, there is also a financial incentive for being honest (Bashir, 1990).

(3) The formats of contracts should be designed as honesty-compatible by including some specific incentive mechanisms such as providing stake in the ownership, linking transfer of ownership through granting bonus shares on the performances, build reserve scheme to induce to hold company shares and provision for profit-related pay linking with the declaration of profits etc. to reduce the agency problem though agency is very much inherent in the very ownership structure.

(4) The redeeming PLS can be effectively used for the promotion of entrepreneurs and projects. Islamic banks can undertake projects with infant entrepreneurs and gradually transfer their sole ownership in case of mudaraba and partial or shared ownership in case of musharaka (it may be called diminishing mudaraba or diminishing musharaka) to the entrepreneurs. This redeemable process could provide an incentive to reduce the moral hazard problem of Islamic banks.

(5) Long-standing bank-borrower relationships would improve the efficiency of PLS banking in other ways. For instance, repeated interactions will reduce monitoring costs as the bank becomes familiar with the borrower's auditing systems, and handles their transactions over an extended period. It should then be able to develop a more accurate opinion of borrower performance relative to other firms in similar circumstances and so be better able to tell whether a low reported return is the result of borrower inefficiency, cheating or a sectoral downturn (Levinthal, 1988 ; Haubrich, 1989).

(6) Actively supervised credit by the branch banking system is an opportunity to minimise the information asymmetries that result from distance. Islamic bank's credit officers, if they work and live in the vicinity of the borrowers, enabling them to gauge their reputation and inspect operations more easily and closely , then agency problem might be minimised substantially. Though it will increase some costs of supervision, better than stuck-up situations in credits.

3. The Theory of the Firm - Competence-based, Evolutionary and Reward-Sharing

There are many theories of the firm that has been developed by the economists and sociologists over the time. The important theories which are frequently discussed and developed according to its tenets are, among others, competence-based, evolutionary and reward-sharing.

3.1 Competence-based Theories of the Firm

The competence-based or competence perspective contrasts with the other large set of theories, frequently described as contractual or contractarian theories of the firm. These forces there is not on the developing resources and skills within the firm but on explicit and implicit contracts between employers, employees and other contractors. The contractual approach emanates from the work of Ronald Coase(1937) and emphasises the cost of making and monitoring transactions. But even within itself it includes contracting theories. On the one hand, for instance, there is Oliver Williamson (1975, 1985) who clearly emphasises the distinction between markets and hierarchies. On the other are Armen Alchian and Harold Demsetz (1972) and 'nexus of contracts' theorists such as Eugene Fama (1980) who enforce no such distinction but see monitoring or metering costs as crucial. Another influential contractarian approach to the theory of the firm, centring on a formal analysis of incomplete contracting and the principal-agent problem, has been developed by Oliver Hart, and his associates Sanford Grossman, and John Moore. Despite their differences, all these exponents see the informational and other difficulties in formulating, monitoring and policing contracts as the crucial explanatory elements. In particular, work in the Coase-Williamson tradition is described as "transaction cost" economics, because of its emphasis on the costs of formulating, enforcing and monitoring contracts.

Competence-based theories of the firm are not uniform or consistent, because a variety of approaches could be grouped under this heading. However, the genesis of the competence-based theory of the firm can be traced back to Adam Smith. In his 'Wealth of Nations' (1776) Smith argued that the division of labour within the firm meant that workers could specialise and enhance their skills through learning by doing. Labour productivity and greater demand for products thus increased. Like Smith, Marx (1876) in Das Capital also put emphasis on the dynamic processes of production. However, with the rise of neo-classical economics in the 1870s, attention was shifted

away from the processes and towards the market. The firm became represented less as an organisation and more as a set of cost and revenue curves. Although he was responsible for much of this neo-classical analysis, Marshall (1949) also emphasised other factors : 'capital consists in a great part of knowledge and organisation... knowledge is one most powerful engine of production... organisation aids knowledge ; it has many forms... it seems best sometimes to reckon organisation apart as a distinct agent of production.'

Almost a century and a half after the appearance of 'The Wealth of Nations', another major milestone in the development of the competence-based theory of the firm was established by Frank Knight (1921). Knight gave much greater stress to the role of knowledge in his theory of the firm and emphasise the pervasiveness of uncertainty. Knight saw the firm as a means of coping with uncertainty by 'grouping' together activities in larger units of organisation. Like Knight, Penrose (1959) saw the firm as the organised combination of competencies : 'a firm is more than an administrative unit; it is also a collection of productive resources the disposal of which between different users and overtime is determined by administrative decision'. The centrepiece of her theory was the dynamic development of tacit knowledge and other capabilities.

3.2 Evolutionary Theories of the Firm

Evolutionary approaches to the theory of the firm often invoke the biological metaphor of natural selection. The classic example here is the siminal work by Richard Nelson and Sidney Winter : "An Evolutionary Theory of Economic Change" (1982). Exponents of evolutionary approaches argue that they provide better theoretical tools to understand technological and organisational change within the firm, especially when compared to the more static, equilibrium-oriented approaches of neo-classical economic theory.

The development of the evolutionary theory of the firm is largely a post-1945 phenomenon. In part it emanates from a famous controversy about the assumption of profit maximisation in economics. However, evolutionary theories of the firm pay more attention to processes of learning and development within organisations. The agent is an explorer and creator rather than a strict maximiser. The firm is a changing organism, typified by both reactive and purposeful behaviours. Evolutionary theories, however, can be regarded as a subset of a wider class of competence-based theories of the firm, which have applied to the strategic management. This approach also addresses key strategic questions such as the identification of possibilities for advantageous vertical integration.

3.3 Reward-Sharing Theories of the Firm

An owner-managed firm is a contractual organisation of some inputs with joint input production, several input owners and one party common in all contracts of the joint inputs who can : i) renegotiate any input contract independently of contracts with other input owners, ii) holds the residual claim ; and iii) has the right to sell his contractual residual status (Dar and McFarquhar, 1996). They have explained the reward-sharing theory of the firm on the basis of cost as a prime factor. In their words : 'The production of goods and services usually requires a large variety of inputs, including financial resources, risk-bearing services, and decision making. The firm does not necessarily own all these inputs. Rather it can own on rent land and other physical inputs. Labour is an unalienable resource; its ownership can not be exchanged. It can only be rented. Capital may be acquired through debt or equity. The risk-bearing services and decision-making services are owned by the owner-manager himself. Choice between these alternatives depends upon : transaction costs, monitoring costs, opportunity costs, physical costs and risk attitude of the owner-manager.' This cost-based theory of the firm has developed a model on reward-sharing mechanism of production relations. They explained that : 'The model follows the new institutional theory of the firm which takes the firm as i) a set of non-human assets over which owner has residual right of control (Moore) ; ii) as an institutional response to high cost of using the price mechanism (Coase, Williamson) ; and iii) to the greater benefits of team-work as opposed to market (Alchian and Demsetz)'.

The main focus of the reward-sharing theory has been placed on the agency costs. Employment and investment decisions have also been analysed in the light of the agency. However, this institutional theory of the firm show the relationship between the various agents in the firm production processes specially of the capital-owner and entrepreneur. Like reward-sharing theory, there are many contractual modalities in the Islamic production relations and

processes which may also be developed. The areas are net-income sharing, gross-income sharing, output sharing on the basis of muzaraa and musaqat etc.

4. The Nature and Characteristics of the Islamic Theory of the Firm

The whole argument in support of the Islamic economic system is based on the assumption that 'Islamic man's human nature' is different from that of 'economic man'. It therefore follows that each type of man pursues the maximisation of his different objectives, and has a different rationality. An analysis of the behaviour of Islamic producers has to be based on what is considered to be the appropriate behaviour of the Islamic producer in relation to the Islamic objectives of the firm (F, Nomani & A. Rahnema, 1994). The rights and duties of various parties in contractual arrangements have been cleared by the Fuqahas or jurists.

4.1 Restrictions of the Islamic Firm

Achievement of 'Falah' or welfare, according to Islamic law (Shariah), is a main focus of human activity in the world. So, the Islamic producer, like the Islamic consumer, will try to maximise his falah in this world keeping in view the welfare of the hereafter. The Islamic producer thus ethically bound to those productive activities which conforms the goals of the Islamic shariah. The process of production in an Islamic firm should be governed by the following golden ethical rules of the shariah :

i) Maximisation of social utility of public interest (**maslaha**) ;

ii) Prohibition of inflicting injury on or causing grief to others (**la zarar va la zirar**) ; or the minimisation of social disutility (**mafsada**) ;

iii) Primacy of social benefit over private benefit ; facilitating life for others and relieving them of difficulty and hardship (**osr va haraj**) especially under conditions of dire necessity and imperative need (**zarurat va izterar**) [F. Namani & A. Rahnema, 1994). Therefore, rational Islamic producer behaviour will be motivated by these norms.

4.2 Objectives of the Islamic Firm

The objective of the Islamic firm will be two-fold : profit maximisation and as well as welfare or falah maximisation. An Islamic firm will consider the benefit of the whole society as well as the other priorities of the Islamic state.

4.3 The Basic Characteristics of the Islamic Firm

1. Islamic firms are bound by the ethical rules of the shariah to provide sufficient quantities of basic necessities at lower prices to enable all members of the society to command such goods.

2. The Islamic firm is expected to operate at a level of output at which total revenue is equal to total cost. But some economists also found it justified that the production will be optimum under the equalisation of marginal cost with marginal revenue or MR = MC.

3. The Islamic producer might reject the prevailing market wage as 'uniform', and adjust to a higher wage which he deems to be 'just' (Siddiqi, M N).

4. The firm's driving force will be co-operation and mutual responsibility with the labour and capital and with the entrepreneur and capital.

5. Principles of contracting such as : Mudaraba, Musharaka, Bai-Salam, Istisna etc. must be clear from riba, gharar and Maysir.

6. The rights and responsibilities of the contracting parties must be pre-determined as the nature of the contract.

From the Islamic point of view, the dichotomy between owners and managers is clearly recognised. In the case of Mudaraba, Rabb-al-mal is the owner of the company while the mudarib has the decision making powers. However, the basis of Islamic separation is the concept of Amanah(trustworthiness). The mudarib is an agent working on behalf of the owner in a trustworthy fashion. He will try to serve the interest of the company rather than his own selfish motives (Iqbal, M). Metawally opined that 'the principle of economic trusteeship in an Islamic economy is dramatically opposed to the self-interest principle which is the corner stone of the free market economies of non-Islamic societies. This clearly suggests that the object of an Islamic firm will not be profit maximisation. Rather, the firm may be satisfied to realise a 'reasonable' or 'fair' level of profit if that enables it to achieve the more important goal 'doing good to please God'.....

The financing part of firm's decision making attracted a separate analysis in the corporate finance literature. According to the well-known Modigliani-Miller Theorem, the debt-equity ratio of a firm does not have any significant influence either on the output level of the firm or on the value of its shares etc. This proposition can not be subscribed under the Islamic firm, because of the prohibition of the interest. However, it has been shown by Adrian Wood that the financing decision does have a bearing on the equilibrium level of the firm (A Theory of Profit, Cambridge, 1975). Badal Mukharjee in a study has shown that a zero rate of interest economy generates equlibria that involves higher growth rates and lower profit margin than an economy having positive rate of interest.

According to M. A. Chowdhury : 'the conclusion gained from Islamic economic treatment of the theory of the firm is that all such approaches have remained neo-classical in essence, and nothing has been gained either in terms of analytics (models) or methodology (epistemological). The essential need for the knowledge parameter in the entire theme of the theory of the firm necessitates an organisational theory that interacts, integrates and dynamizes the firm as an entity like many other ones in the hub of nexual interrelationships in an Islamic political economy'. He suggested 'shuratic approach' of the Islamic firm. In his words : 'the methodology here is to invoke the shuratic approach both within the firm and between it and intersectoral flows of relations.....the Islamic firm is an organistic agents of the Islamic political economy engages in a 'global' process of interactions (decisions=knowledge flows), integration (social consensus) and creative evolution (diversification and growth). Just like all other elements of the Islamic political economy, the Islamic firm is an agent in the shuratic process that links up with the total social order. In this way the Islamic firm derives its rules from the premise of Unification Epistemology in the substantive sense of the embalming methodology in this. Finally, the same methodology of interactions—integration—evolution, which makes the role of the firm alongwith other agencies of the Islamic political economy, to realise the unification process in the real sense.

5. Conclusion

In conclusion, we may say that Islamic business contracts has manifold avenues and modalities to be implemented as according to the suitability of time, place and environment. The essential benefits of the Islamic business contracts is to ensure the benefit of the both partners in the contract. Since the contract for business organisation or production process embodies some sort of problems like principal-agent problem due to information asymmetry and moral hazard, this also be easily minimised in an Islamic mode of contract. As regards the theory of the Islamic firm, it may be assumed from the previous dicussion that considering all internal and external active forces in the functions of the Islamic firm that Islamic firm has an in-built tendency to maximise the welfare of the society and producers will behave as an efficient entrepreneur and as well as an Islamic man to honour the goals of Islamic Shariah for achieving the social welfare and will put whole endevour to maximise production at the level where total revenue is equal to total cost. The basic needs approach will be considered as a primary tool for designing production plan under shuratic process. Agent will be remunerated as per his honesty and capabilities. Therefore, it may be said that If in an Islamic economy, Islamic firm implements the business contracts as designed and approved by the shariah, then principal-agent problem will be minimised and society will be more benefited from

the welfare motive of the producer and other market agents.

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