ISLAMIC PRINCIPLE OF CONTRACT: DEVELOPING A NEW APPROACH IN THE CONSTRUCTION INDUSTRY

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ABSTRACT
At present, the application of the Islamic law of contract in banking and insurance sectors has received positive response worldwide. The high demand for Islamic-based products attracts an increasing number of commercial banks to explore its advantages. The construction industry deals with project development, where project financing could have been supported by Islamic funding. The fundamental principle of project development is that the basic contract for the entire project is still implemented based on the conventional system. Thus, research has to be conducted to examine the possible application of the Islamic law of contract in the construction industry. The current paper starts with an argument that the determination of the type of contracts used in the construction industry is based on the selected procurement method, thus affecting project performance. Interestingly, a number of western studies view contracts in line with Islamic contracts, providing a good theoretical background on the development of the Islamic Contract muamalat in the construction industry. The present work ends with a review of two possible Islamic contracts that are suitable for the construction industry.

KEYWORDS
Islamic law of contract, construction industry, procurement system, al-Muqawalah, al-Istisna’, and al-Ijarah

INTRODUCTION
Similar to other countries around the world, the Malaysian construction industry continues to face countless problems that threaten to hinder its development and sustainability if not addressed and managed effectively. A number of influence factors, particularly related to productivity, quality, time, and cost, have posed significant challenges to the development of this industry (Hamzah, 2003; Imtiaz and Ibrahim, 2005; Pratt, 2000; Rashid et al., 2006). Different procurement systems will have different effects on cost, time, and quality of a project. Furthermore, various changes and demands of the industry will affect the productivity and efficiency of the entire industry supply chain. These needs and demands have to be addressed through the careful selection of procurement routes to ensure proper project performance.

Three types of procurement systems are employed within the Malaysian construction industry, namely, traditional, design and build (D&B), and management (Hasyim et al., 2006; Rashid et al., 2006; Seng and Yusof, 2006; Ismail et al., 2006; Adnan, 2008). Numerous project development failures have occurred, especially in public projects, since the adoption of new procurements or alternative systems. For example, private military contractors PMCs that supervise and manage the majority of government projects, failed to control the costs, design, and scope of a number of public projects, resulting in higher costs (Ibrahim et al., 2010). According to Nitithamyong and Tan (2007), the Ministry of Works revealed in 2003 that several public projects handled by a few PMCs were not completed within the scheduled time; worse, this system was said to yield poor workmanship (Kerk, 2003; Mohamad, 2004). Hamzah (2003), Imtiaz and Ibrahim (2005), and Pratt (2000) noticed that several projects were ineffective in terms of cost, time, and quality.

Empirical research on the procurement system used in the Malaysian construction industry showed that the traditional system still dominates the industry, with the increasing use of D&B and Turnkey contracts (Jaafar, 2010). Industry players agreed that the existence of the significant problem of dispute in each dominant system affected project outcomes. Both client sectors also highlighted the significant problems on legalities, risk, capabilities of parties involved, delay, and costing. Based on the interviews conducted, the respondents agreed that the development of the Malaysian procurement system is unclear, thereby resulting in a hybrid system that is being modified for certain purposes.
FROM THE TRADITIONAL TO THE ISLAMIC APPROACH

Considering the abovementioned problems, the current study attempts to propose a new approach for the construction industry from the perspective of the Islamic contract. Each procurement system is bound by a specific contract. Contracts generally contain provisions that allocate a balance of responsibility, reward, and risk (Turner, 1990). Construction contracts have been drafted to suit specific procurement methods and to determine the level of responsibility, reward, and risk for each party involved. Contracts are undeniably the most important factor in procurement systems that determine project performance.

The rationale for the development of the Islamic contract in the construction industry includes the following:

1. The Islamic law of contract has been widely used in the Malaysian banking and insurance sectors. The use of the Islamic contract started with the establishment of Bank Islam in 1983. Considered as one of the pioneer Islamic banks in the world, Bank Islam has adopted different kinds of Islamic Finance for the use of Muslim consumers. The significant effect of Islamic finance has forced commercial banks to follow suit. However, research on the use of the Islamic law of contract in the construction sector is limited, even in Muslim countries.

2. The Malaysian International Islamic University, through its Procurement and Project Delivery System Research Group, has considered the application of a Shariah-compliant contract for construction projects (Khairuddin, 2007). However, their research focuses on the examination of each condition specified in the Standard Form of Contract from the perspective of the Shariah-compliant contract.

3. In Islamic principle, the contract is the primary consideration for Islamic Shariah and must be free from riba, gharar, or uncertainty, any element of gambling, deception and other unethical issues, danger, and unfairness and must be based on mutual consent. These issues are implicitly practiced and are not allowed by the Islamic Shariah law of contract. At present, the local construction industry is based on the conventional procurement system, where contract implementation is solely based on Western philosophy. This condition provides a strong justification for Islamic contract development.

4. One important category of these origins has emerged from the nature of the local environment practiced since earlier periods. The local construction industry has been using "price in advance" contracts that are utilized in the dominant procurement system. A large number of disputes emerged from the system, along contract manipulation and demands for a better and more equitable contract to safeguard all the parties involved and to improve the situation. The use of Islamic contract will have a significant effect on the supply chain of the entire construction industry, especially because this industry is related to many other sectors.

Based on the rationale and research gaps, the objectives of the present paper are based on the theoretical foundation linking the procurement systems, conventional contracts, and the Islamic law of contract. The primary focus of the current work is a fundamental approach on procurements and contracts. The Islamic principle of contract in the construction industry, which includes the Islamic Shariah Contract, Al Istisna’ and Al Ijarah, is discussed.

A FUNDAMENTAL APPROACH TO ISLAMIC CONTRACTS

A review of related literature reveals numerous definitions of procurement, with an emphasis on different aspects. The current paper will adopt the definition from Ashworth (1991), which is related to the type of contract, obligation, rights, and liabilities of the parties involved, particularly clients, consultants, and contractors. This phrase can clearly illustrate a scenario wherein a group of people are brought together and organized systematically in terms of their roles, duties, responsibilities, and interrelationships to construct a building for a client. Procurement will result in a contract signing between parties to construct specific projects as requested by clients.

Aside from the existence of various types of building contracts, Ferry (1972) and Turner (1990) view building contracts from different perspectives. They categorize construction contracts into two:

1. Cost reimbursement and
2. Price in advance
In a cost reimbursement contract, the contractor agrees that all expenditures on labor, materials, and so on, will be shouldered by the client, on top of which an agreed-upon fee will be charged (Ferry, 1972). Cost reimbursement will be used when the contract sum is obtained based on actual costs of labor, plants, and materials used, plus an agreed-upon allowance for overhead and profit (Turner, 1990). Examples of cost reimbursement contracts include cost plus percentage, cost plus fixed fee, direct labor, management contracts, and target cost. In “price in advance,” the contractor agrees to fulfill his obligations for a predetermined amount. Examples of “price in advance” contracts include lump sum; contract based on bills of quantities, including bills of approximate quantities, negotiated tender, and serial contracting; schedule of prices, and package deals.

Cost reimbursement is used when measuring the approximate quantity of work is inappropriate because of the unusual nature of the project. This approach has significant flexibility in terms of change in scope, program, and quantity of work. The contractor risk, in contrast with the client risk, is low in this approach (Turner, 1990). Ferry (1972) argues that cost reimbursement will allow the client or the representative to give orders on the method of work and to obtain detailed allocations on actual site cost. On the other hand, the contractor does not have to pay for the materials used and only charges for wages, plus a certain profit level. The disadvantage of this approach is that the contractor has no incentive to control wastage.

Two approaches are directly employed in current practice, namely, direct labor and management contracts. In direct labor, the client employs laborers, purchases materials, and engages a subcontractor in a series of minor contracts. In management contracts, a professional management team is employed to organize the project on behalf of the client. The team will employ suppliers and subcontractors based on cost reimbursement and in some cases, the “price in advance” method may be practiced.

In the “price in advance” method, the client/representative has no control on the cost, detailed method, programming, and expenditures because the terms of the contract have been agreed upon in advance. However, the contractor will be incur high risk because the building has to be completed based on the predetermined price (Turner, 1990). Inflation will pose a great risk to the contractor. The “price in advance” method is used globally in the construction industry, with approaches that include traditional and alternative systems, such as D&B and Turnkey.

THE CONCEPT OF CONTRACT IN ISLAMIC LAW

In Islamic law, the term “contract” is normally translated into Arabic as ṣaqd (pl. ṣuqud). Lexicographically, ṣaqd is a verbal noun derived from the root “ṣ-a-ṣ-da” (ṣ.q.d.), which literally means tie or bond (al-Zubaydi, Taj al-ʿArus, p. 436 437 and Mahmasani, al-Nazarīyyat al-ʿAmnāh, p. 264).

In legal usage, Muslim jurists have defined an “ṣaqd” contract as “the obligation and engagement of two contracting parties with reference to a particular matter. It expresses the combination of offer and acceptance. In the conclusion of contract, both the offer and the acceptance are interrelated in a legal manner, the result of which is seen in their mutual relationship (The Mejelle, p. 103–104).”

Based on the definition given by the Majallah, the requirement of the existence of “two contracting parties” and the need for the “combination of the offer and the acceptance” are clearly stated. This definition means that by far, the most common and consistent use of the word ṣaqd was in relation to transactions that were concluded by offer and acceptance.

However, the term ṣaqd has also been used to describe transactions that, in the opinion of some jurists, are concluded by the offer of only one party and do not necessarily involve acceptance and consideration, such as gifts (Certain Hanafi jurists hold that for a gift, only an offer is necessary and acceptance from the other party is not a necessary element. The evidence for this practice is that when someone swears that he does not want to make a gift of any of his property, but then he offers a gift to someone else. The giver is considered to commit a sin, although the person who is offered that gift refuses to accept it. This condition occurs is because according to jurists, the contract is concluded despite the absence of the acceptance of the other party (See al-Jaziri, al-Fiqh ʿala al-Madhhahib al-ʿArbaʿah, p. 293) and gratuitous loans. The term has also been used to describe some juristic acts, including divorce and the release of debts (Hamid, 1969). Thus, two concepts can be derived from the term ṣaqd as follows:

i. The term “contract” as the umbrella term to cover a large spectrum of general legal acts and obligations.

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ii. The term “contract” as referring to the bilateral acts concreting the private relationship between two interested parties (Rayner, 1991)

**Modes of Business Contracts in Islam**

Abdelsalam et al. (2009) enumerated the following modes of business contracts in Islam:

- Al-Mudaraba (Partnership)
- Al-Bai’bithaman Ajil (Sale and purchase)
- Al-Murabahah (Sale and purchase on a cost plus basis)
- Al-Musharakah (Equity financing)
- Al-ijarah (Lease)
- Salam (Advance purchase)
- Istisna or Al-Muqawalah (Manufacturing contract)
- Takaful (Insurance)

**THE CONTRACT OF MUQAWALAH IN CONSTRUCTION INDUSTRY**

According to the Committee of Islamic Fiqh, the al-Muqawalah contract is a contract whereby one of the contracting parties agrees to manufacture a product or perform work that is equal to the payment promised by the other party. This concept is called al-Istisna’ (manufacturing contract) by the fiqh scholars. When the contractor advances only the work in a contract, fiqh scholars call this al-ijarah (Lease) on the work [Resolution No. 129(14/3) of The Council of the International Committee of Islamic Fiqh of Organization of Islamic Conference, 2003].

**al-Istisna contract**

A construction contract, from an Islamic point of view, falls under Istisna’ in the classical jurist books, in particular, the Hanafi School of Thought. The scholars have exercised their Ijtihad and concluded that the construction contract is known today as the equivalent of Istisna’ (Umar Ahmad, 2008; al-Ashqar, 1998). In Arabic, the term Istisna’ means “making, manufacturing, or constructing something.” An Istisna’ contract is therefore “a contract with a manufacturer to make something as demanded by the client using his own materials... (Al-Bashir & Al-Amine, 2001)” Therefore, Istisna’ is a contract for the sale of specified items to be manufactured or constructed with an obligation on the part of the manufacturer or contractor to deliver them to the customer upon completion (Khairuddin, 2007 and Akhtarzaite, 2006). However, for Istisna’ to be valid, the price should be determined with the consent of the parties and the necessary specifications of the commodity (intended to be manufactured) should be fully settled.

The contract of Istisna’ creates a moral obligation for the manufacturer to produce the goods, but before the work is started, any of the parties may cancel the contract after giving due notice to the others (Taqi Usmani, 1998). However, after the manufacturer has started production, the contract cannot be cancelled unilaterally (Taqi Usmani, 1998). In Istisna’, the manufacturer undertakes to produce the required goods using his own materials. Therefore, this transaction implies that the manufacturer shall obtain the materials, if it is not already in stock, and shall undertake the work required for the production of the ordered goods using them. If the material is provided by the customer and the manufacturer is required to provide only labor and skills, the transaction is not Istisna’. In this case, the transaction will be Ijarah, whereby the service of a person is engaged for a specified fee (Taqi Usmani, 1998).

**al-Ijarah contract**

“Ijarah” is a term of Islamic fiqh. Lexically, this term means “to give something on rent.” In the Islamic jurisprudence, the term “ijarah” means “to employ the services of a person on wages given to him as a consideration for his hired services.” This type of ijarah includes any transaction wherein the service of a person is hired by someone else. The hiree may be a doctor, a lawyer, a teacher, a laborer, or any other individual who can render valuable services. Each of these individuals may be called an “ajir” based on the terminology of Islamic law. The person who engages the services of an “ajir” is called a “mustaj’ir,” whereas the wages paid to the ajir are called “ujrah” (Taqi Usmani, 1998).

In this type of contract, the contractor performs certain work only with the materials provided by the client. The administration and supervision of the project are handled by the other contractual party who owns the project. In this contract, the project owner is the one who provides the materials, whereas the contractor only owes a duty to use the materials in performing the work in accordance with the specifications (Ahmad, 2008; Husein, 2006).
In the Mahdi Umar Ahmad (2008) *ijarah* construction contract, the contractor is not liable for any loss of materials because they were not kept under his custody. More importantly, the contractor in an *ijarah* contract does not to purchase the raw materials.

**CONCLUSIONS**

The Western approach on contracts specified by Ferry (1972) and Turner (1990) has a similar background and concept as that of the Islamic law of contract. The “price in advance” or *al-Isitina* contract poses a high risk to contractors, whereas the cost reimbursement or *al-Ijarah* contract places a high risk on the client.

A large number of projects in the Malaysian construction industry today practice the “price in advance” or *al-Isitina* contract. In a typical scenario for public projects, the primary contractor can earn up to a 10% profit (depending on the type of negotiation with client), allowing them to further subcontract the project to subcontractors. In most cases, the multilayered subcontracting practiced in the industry resulted in a large number of disputes and problems, including unfair and delayed payments to the subcontractor. The current practice of multilayer subcontracting resulted in the existence of management contractors (with no specialty), high dependency on domestic subcontractors, issues on corruption, and delayed and unfair payments to the bottom of the supply chain, among others. Operating businesses or projects with minimum profit will adversely affect business survivability. These issues seem to pose a major effect on the operations of contractors and subcontractors and are strongly linked to the high rate of business failure in the construction industry.

In contrast, a cost reimbursement or *al-Ijarah* contract only allows contractors to be paid based on their work, with an acceptable allowance for profit and attendance in the case of direct sub-labor. For large projects, the management contract system allows the involvement of professional advisors to manage all suppliers and expert subcontractors (not necessarily domestic contractors), who are hired for a particular project and who do the work based on their specialties. This type of contract does not allow the hiring of an inexpert management contractor and the utilization of multilayered subcontracting. This practice will enhance the advancement of the construction industry in terms of skillful workers and higher expertise of subcontractors. This contract could also minimize related unallowable practices in Islamic contracts to enhance fairness, which also benefits all industry players. However, a number of questions remain unanswered in the search for a dynamic Islamic contract in the construction industry. To achieve business sustainability and competitive advantage in the construction industry, the current work proposes that subsequent research on this area be conducted in the future.

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