

Sharia Compliance and Economic Efficiency in Minangkabau Traditional Sharecropping

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ABSTRACT

Islamic financing contracts currently marketed in Indonesia use Arabic terminology that might sound strange to many Indonesian Muslims. Even though these financing contracts comply with the Sharia components, they may be inefficient in the context of local wisdom. This paper identifies traditional contracts that are potentially modified to become Sharia compliance. We analyzed the traditionally practiced business contracts of sharecropping in Minangkabau West Sumatra and tested whether the contracts fulfilled sharia compliance and economic efficiency. We interviewed seventy practicing sharecroppers and fourteen local leaders and clerks to seek their perceptions about two types of Minangkabau traditional contracts of *paduo* and *patigo*, regarding economic efficiency, fairness, and sharia compliance. We found that the respondents generally believed that the practiced sharecropping contracts fulfilled most Sharia requirements. However, the need for the written agreement, presence of witnesses, and definite duration were unsatisfactory to avoid *gharar*. The majority of respondents believed that the contracts were fair but inefficient. Modification of contracts in terms of proper legal drafting, presence of witnesses, and finite duration are necessary. The modified contracts will be beneficial to support the emergence of formal Islamic financial institutions which are culturally compatible.

Keywords: Minangkabau culture, adverse selection, sharia compliance, Sharecropping contracts, moral hazard.

INTRODUCTION

Islamic financing contracts currently marketed in Indonesia use Arabic terminology that might sound strange to many Indonesian Muslims. Even though these financing contracts comply with the Sharia components, they may be inefficient in the context of local wisdom. Meanwhile, the Minangkabau tribe in West Sumatra, Indonesia, has long practiced traditional sharing contracts using the profit loss principle (PLS), the main principle for Islamic Financial Institutions (IFIs).¹ These traditional sharing contracts are likely culturally efficient but might not be fully Sharia compliant.

The Minangkabau community has long practiced sharecropping contracts with PLS principles, which they call *paduo* (make two parts) and *patigo* (make three parts), both refer to profit sharing ratio. *Paduo* is the type of *musyarakah* where the land owner and the cultivator split the profit equally half. *Patigo* is

the type of *mudarabah* where the land owner gets a third, and the cultivator receives two-thirds of the profit. In *paduo*, the land owner contributes to the project's cost, but in *patigo*, the cultivators bear all the cost. *Paduo* and *patigo* are familiar to the Minang people, unlike their counterparts, *mudarabah*, and *musyarakah*, which use Arabic terminology.

This research analyzed the two existing Minangkabau's traditional contracts regarding economic efficiency, fairness, and sharia compliance. We examine the sharecropping contracts practiced in Koto VII District, Sijunjung Regency, West Sumatra Province. From this research, we hope to identify traditional Minangkabau contracts that might be modified to enrich Islamic financial products in Indonesia. Hence, our study's novelty is identifying practiced traditional contracts enabled to fulfill Sharia requirements. The modified contracts will be beneficial to support the emergence of formal Islamic financial institutions in the region.

The paper will proceed into four sections. The next section discusses the nature, definition, and problems of Minangkabau sharecropping contracts, followed by the methodology section. After a discussion of the findings, the final section is the conclusion.

LITERATURE REVIEW

IFIs that have grown and developed in Indonesia in recent decades have also well-developed in the Minangkabau community. Joint research conducted by Bank Indonesia of West Sumatra and the Andalas University Research Institute confirmed that the community approves the establishment of IFIs in their regions.² Furthermore, Islamic finance is positively related to the gross domestic product of a region, both in the short and the long term.³ Although the community's support for the existence of IFI has been excellent, numerous community members still have poor knowledge about the principles and phrases used in the operations of IFIs.

The people of West Sumatra are relatively homogeneous, in which the tribe of Minangkabau is the dominant population. Minang people are inherently Muslims since they express their customs and religion as "*Adat Basandi Syarak – Syarak Basandi Kitabullah* (Custom is based on Islamic law – Islamic law is based on Holy Quran)" and "*Syarak mangato – Adat mamakai* (Islamic law rules – Custom executes)," which means that the source of customs is Islamic laws and the source of Islamic laws is the Holy Quran.⁴ The Minangkabau tradition has adopted two main principles related to economic affairs: balance and justice.⁵ Both principles align with the basic principles of Islamic economics.⁶ The balance element consists of modesty, prudence, and un-wasteful, and the justice element consists of social justice and fairness of income distribution. The value of social justice is contained in the customary jargon "*mandapek sama balabo, kahilangan samo marugi, maukua samo panjang, mambilai samo laweh, baragiah samo banyak, manimbang samo barek* (if we make profit both of us get some profit, if we suffer loss both of us share some loss, we measure with the same length, we connect with the same width, we share with the same weight, we weigh with the same weight)." The value of fairness is contained in the customary jargon "*Gadang kayu gadang bahannyo, ketek kayu ketek bahannyo* (big woods need more materials, small woods need fewer materials)," which means that those who have more powers have more responsibilities. In addition, the value of fairness in income distribution is reflected in the jargon "*nan lamah makanan tueh, nan condong makanan tungkek* (the weak need to be supported, the slanted need to be backed)."⁷ These principles of justice and fairness illustrate that the Minangkabau community has implemented a profit-sharing system, both profit and loss.

A PLS contract is a contractual agreement between two parties where each party collects resources, invests the resources in a project, and then shares the profit or loss. In Islamic finance, PLS is mainly characterized by two key transaction types: *mudarabah* and *musharakah*.⁸ In *mudarabah* contract, the capital is provided by one of the parties to the partnership. This party, called the *rabb-ul-maal* – the ‘owner of wealth,’ can be considered a land owner. The other party, called the *mudarib* – the project manager, provides the expertise, effort, and management in undertaking the business project. In a sharecropping contract, the manager is a cultivator. The two parties agree on a profit-sharing ratio upfront. In case of failure, landowners will bear any losses in terms of capital contributed, and the cultivator will lose the time invested in the project. In contrast, in the *musharakah* contract, all parties contribute to providing capital. All parties can participate in the management, and all parties benefit from the capital appreciation of the investment. All parties bear losses proportionate to their respective capital contributions.

The problem surrounding most business contracts, including PLS, is the agency problem.⁹ The problem arises because one party has better information about unobservable quality, determining the outcome and payoff. This information asymmetry will increase the risk level of weakly informed agents. Jensen and Meckling, in their 1976 paper, were among the earliest to point out a conflict of interest between principals (land owners) and agents (cultivators) in managing a project and hence termed the principal-agent model.¹⁰ Each party acts in its interests at the other party's expense.

Asymmetric information typically leads to adverse selection and moral hazard problems.¹¹ Adverse selection occurs before the transaction and refers to a situation in which cultivators have relevant information that land owners lack about some aspect of quality affecting the outcome. It happens when the potential cultivators are most likely to produce an undesirable outcome. In banking, bad-credit-risk debtors are the ones who most actively seek out a loan and are thus most likely to be selected. A moral hazard is the consequence of asymmetric information after the transaction occurs. The landowner runs the risk that the cultivators will engage in undesirable activities from the owner's point of view because those activities create a high risk of crop failures. The adverse selection and moral hazard are potentially problematic with Islamic profit-sharing contracts.¹²

Due to problems with asymmetric information, the contracts must be designed appropriately and optimally to ensure all parties benefit. For an optimal contract and to achieve mutual benefits, the contract offered by the owner to the cultivators must have two main elements: efficiency and fairness.¹³ The contract will be efficient if it induces the cultivator's obligation to a maximum level and ensures satisfying incentives. The contract is fair in terms of risk management if more risk is borne by those who are less risk averse, which usually is the owner.

The literature on Islamic contracts has been dominated by Islamic banking, for example, comparing the stability of Islamic and conventional banks¹⁴ and investigating Sharia concerns on existing banks' resolution framework.¹⁵ Although some studies of Islamic contracts tend to include integration between Islamic social finance and Islamic commercial finance,¹⁶ to our knowledge, the study of Islamic contracts focusing on Islamic sharecropping is very scanty. Islamic finance contracts likely have fulfilled the elements of Sharia compliance, but they may not necessarily be economically efficient if implemented on sharecropping. On the other hand, traditional sharecropping contracts may be economically efficient but may not necessarily meet the elements of Sharia compliance.¹⁷

RESEARCH METHODS

This study used a qualitative method with an interactive model developed by Miles and Huberman in their 1994 *Qualitative Analysis* textbook.¹⁸ In 2014, they extended this base four-stage method to be interactive.¹⁹ The first stage was data collection. We interviewed cultivators and landowners practicing traditional sharecropping contracts, followed by in-depth interviews with community leaders. The second stage was data condensation, which refers to selecting, focusing, and transforming the data. The third stage was data display in the form of tabulation, ready to be analyzed. The final stage was conclusion drawing and verification. The last three stages were done interactively.

This research was conducted in Koto VII District, Sijunjung Regency, West Sumatra Province. The reason for choosing this location was that most of the people in the area entered into a production-sharing contract. We employ a purposive sampling technique to select respondents in the research area. The sample criteria in this study were cultivators and land owners who cooperated with a system of profit sharing in the Koto VII District. The district comprises seven villages: Nagari Limo Koto, Nagari Palaluar, Nagari Tanjung, Nagari Guguk, Nagari Bukit Bual, Nagari Padang Lawas, and Nagari Padang Lawas Selatan. From each village, we took as many as 12 respondents: five respondents were owners of rice fields or rubber gardens, five respondents were cultivators, one respondent was a traditional leader, and one respondent was a religious figure. The number of respondents in this study was 84 respondents: 70 with questionnaires and 14 with in-depth interviews. The total number of respondents for the semi-structured interview and in-depth interviews were sufficient to guarantee data saturation, which requires only 9-17 interviews to reach saturation.²⁰

RESULTS AND DISCUSSION

Descriptive Statistics

The survey was conducted in the mid of 2018. We present the summary of the respondent's characteristics in Table 1. We tabulate the respondents with questionnaires according to their characteristics and the types of contracts. Most respondents were female, aged over 35 years, high school graduates, and had a monthly income between Rp. 500.000 and Rp. 3.000.000. The table shows that junior high graduates tended to use more *paduo* than *patigo*, but senior high graduates used more *patigo* than *paduo*.

Respondents vary in their knowledge about PLS in IFIs. When we asked whether they knew shariah contracts such as *mudarabah* and *musharakah*, most respondents said they did not know them. Only about a quarter of those who chose *paduo* and *patigo* were familiar with the Sharia contracts. This fact likely supports that PLS in Arabic sounds unfamiliar to the communities, especially rural communities.

Table 1: Descriptive Statistics

Respondent Characteristics	Type of Contract		Total
	<i>Paduo</i>	<i>Patigo</i>	
Sex			
Male	41.03	25.81	34.29
Female	58.97	74.19	65.71
Total	100.00	100.00	100.00

Age			
<25 y.o.	5.13	0.00	2.86
25-35 y.o.	10.26	6.45	8.57
35-45 y.o.	43.59	35.48	40.00
>45 y.o.	41.03	58.06	48.57
Total	100.00	100.00	100.00
Education			
Elementary	20.51	19.35	20.00
Junior High	28.21	32.26	30.00
Senior High	35.90	29.03	32.86
College	15.38	19.35	17.14
Total	100.00	100.00	100.00
Monthly Income			
< Rp. 500.000	2.56	3.23	2.86
Rp. 500.000 – Rp. 2.000.000	41.03	35.48	38.57
Rp. 2.000.000 – Rp. 3.000.000	46.15	41.94	44.29
Rp. 3.000.000 – Rp. 5.000.000	7.69	16.13	11.43
> Rp. 5.000.000	2.56	3.23	2.86
Total	100.00	100.00	100.00
Knowing Sharia Contract			
Yes	25.64	22.58	24.29
No	74.36	77.42	75.71
Total	100.00	100.00	100.00
Field			
Paddy Field	15.38	93.55	50.00
Rubber Field	84.62	6.45	50.00
Total	100.00	100.00	100.00

Source: field survey

Table 1 also shows that traditional sharecropping contracts differ between paddy and rubber fields. The majority of respondents in paddy fields implemented *patigo*, whereas in rubber fields *paduo*. Based on an in-depth interview with community leaders, in paddy fields, cultivators tend to bear all the material costs and therefore use *patigo*. The reason was that the production cycle was short, and the material costs were affordable to cultivators. Whereas, in rubber fields, *paduo* is more familiar because production cycles are pretty long and the material prices are relatively high; therefore, cultivators and land owners jointly contribute to bear the costs.

Adverse Selection

The adverse selection problem presents before the signing of a contract when the party that establishes the conditions of the contract – the land owner – has less information than the other party – the cultivator – on some essential characteristics affecting the value of the contract. In particular, the cultivator’s quality was hidden from the land owner: bad-quality cultivators tend to accept contracts at the cost of failing the project. One of the most important problems associated with adverse selection is that landowners choose not to cultivate the land to avoid being exploited by better-informed cultivators. In extreme cases, adverse selection may prevent the sharecropping business from operating.²²

Table 2: Duration and Priority to Contract With

	Type of Contract		Total
	<i>Paduo</i>	<i>Patigo</i>	
Sex			
<3 years	5.13	0.00	2.86
3-5 years	28.21	16.13	22.86
>5 years	66.67	83.87	74.29
Total	100.00	100.00	100.00
Priority			
Own Relatives	56.41	58.06	57.14
Own Village Residents	38.46	35.48	37.14
Outsiders	5.13	6.45	5.71
Total	100.00	100.00	100.00

Source: field survey

The adverse selection comes from the disabilities of the landowner to reveal the cultivator quality. If the cultivator’s quality is somehow approximated, the adverse selection problem could be reduced. It is a good idea to look at how long and to whom the landowner runs the contract. Table 2 shows the duration of cooperation and the priority to contract with. In both types of contracts, more than 60% of the cooperation between parties has lasted for at least five years. This long duration of the contract implies that the quality of the cultivator, somehow, had been revealed; otherwise, the cooperation was terminated.

If we look at the involved parties, more than 90% of the contracts for both types were between their own relatives or village residents. Only a few contracts were with outsiders. This indicates that the probability of facing an adverse selection problem was minimal as the contracting parties had known each other before the contracts.

Moral Hazard

Moral hazard occurs after the contract is signed, when the cultivator’s behavior is hidden in the relationship and, consequently, cannot be included in the contract terms. The presents of moral hazard imply that when a contract is offered, the land owner needs to consider the effort the cultivator will take after signing the contract. The optimal contract would be determined by the trade-off between efficient

risk sharing and incentives: if the risks are all borne by the land owner, then there will be less incentive to work at the maximum effort.

Table 3: Method, Reasons for Sharing, and Monitoring

	Type of Contract		Total
	<i>Paduo</i>	<i>Patigo</i>	
Sharing Method			
Profit sharing	2.56	29.03	14.29
Revenue sharing	97.44	70.97	85.71
Total	100.00	100.00	100.00
Reason for Sharing			
Together Share Risks	28.21	25.81	27.14
Follow Tradition	69.23	74.19	71.43
Have Long Experience	2.56	0.00	1.43
Total	100.00	100.00	100.00
Owner Monitors			
Never	5.13	6.45	5.71
Occasionally	66.67	67.74	67.14
Often	28.21	19.35	24.29
Frequently	0.00	6.45	2.86
Total	100.00	100.00	100.00

Source: field survey

The moral hazard problem can be reduced by sharing methods and costly monitoring activities. Table 3 presents sharing method, the reason for sharing, and monitoring actions. We asked the respondents whether they used revenue sharing or profit sharing. The majority of contracts were in the form of revenue sharing: almost all *paduo* and more than 70% of *patigo* are with revenue sharing. Only less than 15% were profit sharing. The choice of revenue instead of profit sharing indicates the presence of accountability problems in calculating profit, which can be a source of moral hazard. Most respondents said they followed tradition when asked about the reasons for sharing. Only less than 30% did answer that their main reason was to share risks with the other party. This fact implies that the practice of sharing, especially its revenue-sharing methods, has existed for decades in the community.

Monitoring is important to ensure the cultivator's activities follow points of agreement. When we asked whether the landowner actively monitored the projects, most respondents claimed the monitoring occurred occasionally or often. Only less than 6% of respondents did claim the owner had never monitored. Monitoring activities were more intense in *patigo* rather than *paduo*. This tendency is quite reasonable because in *patigo* the landowners provide the land and contribute to the cultivation costs.

The in-depth interview revealed that among moral hazard problems were cultivators neglecting their obligations. According to the respondents, this problem usually happens due to the landowner's absence of supervision or control. The owner entirely handed over the management of the land to the cultivator based on trust. However, some cultivators abused this situation by taking personal advantage.

If there are disputes, the landowner usually takes action to remind and warn the cultivators to act following the agreement. However, if the deviation persists, then the land owner might cancel the agreement, such as taking back the land or replacing the management with more trustworthy cultivators.

Conflict Resolution

Conflicts are predicted to occur during the contract due to several causes, such as low commitment and false reporting. The procedures to solve conflicts are usually stated in a formal written contract. In traditionally oral contracts, conflict resolution may involve extended families or community leaders.

Table 4 shows contract barriers, conflict experience, and mitigation. The significant sources of contract barriers were time inconsistency and low commitment. Time inconsistency was more likely due to the duration of contracts being unstated clearly. Sometimes landowners take back the land earlier than the cultivators expected. A low commitment was due to cultivators not making sufficient effort to ensure the harvest was successful.

False reporting was only reported a few. False reporting was usually regarding the volume of harvest. False reporting happened more frequently in *paduo* than in *patigo*. This fraud was probably related to monitoring activities by landowners. In *patigo*, because the landowners share the costs, they were incentivized to monitor, hence less false reporting. Meanwhile, in *paduo*, the landowners fully delegate the daily operation to the cultivators, and hence more opportunity for the cultivators to cheat. These barriers indicate the presence of potential moral hazard problems and hence conflicts.

Table 4: Conflicts and Resolution

	Type of Contract		Total
	<i>Paduo</i>	<i>Patigo</i>	
Contract Barrier			
Low Commitment	38.46	25.81	32.86
False Reporting	10.26	6.45	8.57
Time Inconsistence	51.28	67.74	58.57
Total	100.00	100.00	100.00
Conflict Experience			
No	20.51	25.81	22.86
Yes	79.49	74.19	77.14
Total	100.00	100.00	100.00
Conflict Mitigation			
Solve by Negotiation	79.49	80.65	80.00
Involving Clerks	15.38	16.13	15.71
Terminate Contracts	5.13	3.23	4.29
Total	100.00	100.00	100.00

Source: field survey

When we asked about conflict experience, about 77% of respondents replied positively, indicating regular conflict occurrence. Conflicts occurrence were more often in *paduo* than *patigo*. Almost 80% of respondents experienced conflicts in *paduo* compared to less than 75% in *patigo*. If the conflicts are present, they are mainly mitigated with a negotiation or escalated for community leaders to get involved. Only a few were terminated as a result of disputes. This conflict resolution in the community was proven effective because more than 95% of conflicts could be mitigated without terminating contracts.

Risks of Crop Failures

Efficiency in risk-bearing or fairness requires optimal risk sharing because the person who least fears risk bears more risk.²³ Landowners are expected to bear more risks in these sharecropping contracts than the cultivators, especially in crop failures. Therefore, efficiency requires land owners to take more risk of crop failures.

Table 5: Risk Bearer and Additional Incentives

	Type of Contract		Total
	<i>Paduo</i>	<i>Patigo</i>	
Risk Bearer			
Cultivators	7.69	12.90	10.00
Share Loss	92.31	87.10	90.00
Total	100.00	100.00	100.00
Incentives			
Occasionally	56.41	41.94	50.00
Often	43.59	58.06	50.00
Total	100.00	100.00	100.00

Source: field survey

Table 5 mapped the risk-bearing when crops failed and the incentives when the harvest was successful. Regarding crop failures, most respondents shared the loss between landowners and cultivators. However, about 10% of respondents stated that the cultivators bear all the losses. Cultivators bear more risk of crop failures in *patigo* than in *paduo* because the cultivators pay all operational costs. If cultivators were more risk averse than the landowners, this figure indicates the existence of inefficiency in the contract; and this kind of inefficiency is embodied in PLS.²⁴

Regarding crop success, 50% of respondents reveal that land owners gave cultivators a bonus in addition to their share. The stimulus was more often in *patigo* than *paduo*, which is reasonable since in *patigo*, the landowner did not bear the cost of production. These incentives theoretically improve efficiency and reduce moral hazard if stated in the contract.

It seems the cultivators face more risks in *patigo* than in *paduo*. Whenever crop failures happen, cultivators lose more than the landowners; and whenever crop success, the cultivators gain more than the landowners. Referring to Table 1, respondents committing to *patigo* had better education, income, and understanding of Sharia than those committing to *paduo*. These phenomena may indicate that the cultivators with *patigo* contacts were willing to take more risks than those with *paduo*.

Sharia Compliance, Fairness, and Efficiency

Three main Sharia prohibitions impact Islamic finance: the prohibitions of *riba*, *gharar*, and *maysir*.²⁵ *Riba* or interest is the premium the borrower pays the lender on top of the principal amount as a loan condition. *Gharar* means taking excessive risk or having unnecessary uncertainty in a contract. *Maysir* includes all kinds of gambling activities where one can gain significantly or lose depending on how the deal moves. *Riba* and *Maysir* most likely do not exist either in *paduo* or *patigo*. However, the existence of *gharar* may be possible.

Islam requires all aspects of the contract to be transparent and known to all parties to reduce conflict.²⁶ *Gharar* may exist due to a lack of transparency, in which all the parties do not know all aspects of the contract. Table 6 shows the contract record system, the presence of witnesses, and the definite duration. Most respondents stated that their contracts were only based on an oral agreement, not a written one. Most of the contracts have no witnesses and do not have precisely definite duration. The three conditions – lack of written proof, no witness, and undefined termination – can be source *gharar* and hence a source of potential conflicts.

Table 6: Sharia Requirements and Performance

	Type of Contract		Total
	<i>Paduo</i>	<i>Patigo</i>	
Record System			
Written Agreement	28.21	19.35	24.29
Oral Agreement	71.79	80.65	75.71
Total	100.00	100.00	100.00
Witnesses			
No	92.31	87.10	90.00
Yes	7.69	12.90	10.00
Total	100.00	100.00	100.00
Duration			
Did Not State	89.74	96.77	92.86
>2 years	10.26	3.23	7.14
Total	100.00	100.00	100.00
Feeling Fair			
Yes	94.87	93.55	94.29
No	5.13	6.45	5.71
Total	100.00	100.00	100.00
Feeling Efficient			
Yes	15.38	19.35	17.14
No	84.62	80.65	82.86
Total	100.00	100.00	100.00

Source: field survey

Based on an in-depth interview with community leaders, when contracts were between relatives, the contracting parties relied on trust and hence did not use written contracts or witnesses. Only contracts between villagers and outsiders tended to use written agreements with witnesses. Using written agreements or witnesses seems to depend on how close the ties between parties are.

Theoretically, fairness is reflected by risk sharing between contracting parties, and efficiency is reflected by the ability of the contract to exert maximum effort. Subjectively fairness and efficiency can be asked of the respondents. Table 6 also presents subjective fairness and efficiency. Almost 90% of respondents in the two types of contracts stated that they felt their contracts were fair. This indicates that the risk-sharing between parties can be considered optimal. However, when asked about efficiency, most respondents stated that their contracts – *paduo* and *patigo* – were inefficient. This fact confirms the embodied moral hazard in the PLS and the possibility of *gharar* in *paduo* and *patigo* such that the efforts taken by cultivators were suboptimal.²⁷

CONCLUSION

We analyze two of Minangkabau's traditional contracts that existed for decades regarding economic efficiency, fairness, and sharia compliance: *paduo* and *patigo*. These contracts have long been practiced in the region. We found that the two contracts satisfy fairness, where the owners bear some consequences of crop failures. We also found that the contracts comply with the Sharia requirements of forbidding *riba* and *maysir*.

However, in terms of production efficiency, the two contracts fail to boost the maximum effort. This inefficiency is related to a possible existence of *gharar*: poor book record, no witness, and uncertain duration. The presence of likely *gharar* might cause insufficient incentive for cultivators to devote the maximum effort. Therefore, to make the two contracts Sharia compliant and economically efficient, the terms of the contract need to be specified: written contract, legalization, and certainty. In this regard, the involvement of government authority at various levels and local community leaders to enhance contract certainty would make these two contracts more efficient and Sharia-compliant.

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