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Sources of Public Finance in an Islamic Economy

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Abstract

Since interest is prohibited in Islam, the government in an Islamic economy cannot issue interest based T-Bills, T-Bonds and/or obtain interest based sovereign debt. Based on the literature review, it is argued that neither Prophet Muhammad (P.B.U.H) nor the pious Caliphates (rta) levied any taxes other than Zakah. Accordingly, this study explores the sources of revenue for a government in an Islamic economy. In discussing sources of tax revenue, it is maintained that Zakah is the only tax the government in an Islamic economy can levy. Nevertheless, the government can charge service/performance based fees, duties, charges etc in providing public goods. Furthermore, the profitable operations of state owned enterprises form an important part of non-tax revenues. It is also analyzed that how the non-profitable public institutions like police and courts will be funded. This study also discusses that how the government can finance its deficit keeping in view that interest is prohibited in Islam and Zakah rates are very low and Zakah base is very narrow as per common understanding. The study also gives brief insights into how much Zakah can be collected in Pakistan. Finally, it suggests that the nominal GDP growth linked rate of return can be used to benchmark domestic and external loans including those from IMF, WB and IDA etc.

Table of Contents

1.	Introduction	3
1.1	Background of the Study.....	3
1.2	Problem Statement.....	3
1.3	Objectives of the Study	3
1.4	Importance of the Study.....	3
1.5	Research Methodology	3
1.6	Scope of the Study	4
1.7	Limits of the Study	4
2.	Literature Review	4
3.	Institution of Zakat: An Important Source of Public Finance in Islamic Economy	6
4.	Issues in Estimation of Zakat	7
5.	Estimation of Zakat	8
5.1	Calculation of Nisab for Individuals (Exemption Amount)	9
5.2	Zakatable Assets	9
5.2.1	Bank Deposit.....	9
5.2.2	Currency in Circulation.....	9
5.2.3	Import Duty.....	10
5.2.4	Gold	10
5.2.5	Agricultural Income/Produce	10
5.2.6	Services Income	10
5.2.7	Industrial Income	10
6.	Economics of the Proposed Zakat Based Taxation System	12
6.1	Effects of Proposed Zakah System on Property Market	12
6.2	Effects of Proposed Zakah System on Investment.....	12
6.3	Effects of Proposed Zakah System on Equity Markets	13
7.	Non-Tax Revenues.....	13
8.	Funding Non-Revenue Generating Activities	13
9.	Alternative for Public Finance Other Than Zakat	14
	Conclusion.....	15
	Appendix 1: Akram Khan's Comment on A. Azim Islahi & M. Obaidullah: Zakah on Stocks.....	16
	Appendix 2: References.....	17

1. Introduction

1.1 Background of the Study

The role of government in an economy has always been an important issue among economists and policy makers. Economic order sans Government has not appeared in reality in any part of the world throughout the known economic history. At the least, its role as a regulator is however accepted even in a free market economy. In a Keynesian framework though, it has been placed at the center by acting not only as a regulator, but also as an active economic player.

In the midst of Great Recession, the role and importance of government has once again reappeared as an important issue. Indeed, when one looks at the bail out package of U.S government to its financial sector in December 2008 and also to its producing sector later on while also providing huge subsidies to its agricultural sector right throughout the last decade, the government's role is far from being considered minor. In an interest free economy, the key question is that how the broad based development would be achieved let alone reducing fiscal deficits.

In this backdrop, this study takes on important issues in public finance in an Islamic economy. More specifically, it analyzes the sources of tax and non-tax revenue for the government, sources of financing for the government and means of pricing capital in public finance.

1.2 Problem Statement

This study analyzes public finance literature in Capitalism and in Islamic economics on one hand while on the other hand, this study suggests and estimates the means of revenue, sources of finance available to the government to reduce its budget deficit and spend on development in an Islamic economy and the appropriate way to price capital in public finance.

1.3 Objectives of the Study

The study sets forth following important objectives:

1. It suggests the sources of revenue for the government in an Islamic economy.
2. It explores the ground rules for Zakatable assets and Zakatable income found in the study of sources of Islamic faith i.e. Quran, Way of the Prophet Muhammad (P.B.U.H) as well as four primary schools of Islamic jurisprudence. In line with civilizational changes, it endeavors to suggest some modifications inductively as well. These modifications would make the recommendations more relevant and applicable.
3. It estimates the potential of tax revenues that can be collected in Zakah.
4. It also analyzes economic history in early Muslim civilization to decipher and account for some notable principles that can be applied today as well.

1.4 Importance of the Study

The study has significance in academics as well as in public policy making. This study takes a broader approach to help in public policy making and adds to the literature as it discusses more the contemporary developments in both literature and public finance practice. It has explored the means of revenue and source of public finance through and beyond Zakah in an Islamic economy.

1.5 Research Methodology

This study is exploratory and analytical in nature. This study analyzes Islamic economics literature to

clarify various charges of anomalies in the institution of Zakah. It takes into account quantitative data to estimate the potential of tax revenues by using the institution of Zakah and non-tax revenues using various other means available in an Islamic economy. It also gives an analytical appraisal of the proposed system in light of public finance literature.

1.6 Scope of the Study

The study sets forth a determined objective to contribute in public policy making as well as add to the academic literature of Islamic Economics. It also suggests means of financing beyond tax and non-tax revenue collections and the way to price capital in public finance instruments in an Islamic economy.

1.7 Limits of the Study

Due to the unique nature of the institution of Zakah, coming up with the precise measurement of potential of Zakah is a difficult task, more so in the case of Pakistan where there is dearth of documentation. Therefore, the study could only provide preliminary insights into potential of tax revenues through Zakah.

2. Literature Review

In conventional economics, the government has following sources of tax revenue: General Sales Tax, Excise Tax, Custom Duty, Import Duty, Export Duty, Octroi Tax, Property Tax, Wealth Tax, Development Surcharge, Personal Income Tax, Corporate Income Tax, WHT etc. In conventional economics, government can earn through non-tax sources by way of earning through the profitable operations of State Owned Enterprises (SOEs) in public sector. Fines and activity based charges and duties are also an important source of revenue for the government. In conventional economics, if a government needs to finance deficit, it can issue Treasury Bills/Bonds or obtain loans bilaterally or multilaterally. Some governments have gone beyond issuance of Treasury bonds in the local market to issue sovereign bonds in the international market.

In an Islamic economy, the problem comes in the issuance of debt (due to prohibition of interest) and imposition of taxes. In an Islamic economy, as we discuss later, imposition of tax beyond Zakah is not recommendable. Zakah is a combination of a net worth tax and production tax.

Zakah is a religious obligation to pay a part of wealth and production to the government. However, in most countries, Zakah is not collected by the government and is not considered a compulsory payment (Powell, 2009). Respected Muslim scholar Ab-ul-ala Maududi (1970) reasoned that Zakah is a religious obligation and is not a substitute of tax. Taxes other than Zakah can be imposed in an Islamic economy if these taxes are levied by the legislative council and used for public welfare. He reasoned that the taxes discouraged in Ahadith are those which were imposed by autocratic kings for their own lavish consumption and this kind of usurpation of public property was discouraged.

Discussing the issue of distributing Zakah, Islahi (1985) and Qardawi (2000) explained that it is not necessary to make some living person the owner of the Zakah. Zakah can be given to any person or cause or an organization working for a cause. It is not necessary to make some living person the owner of the Zakah.

Mannan (1986) opined that Zakatable goods can be modified as did Hazrat Umer (rta) who levied Zakah on horses; whereas, horses was exempt from Zakah before him. He also noted that since Zakah is a religious obligation, it would result in low tax evasion in the opinion of the author. He argued that Zakah could be distributed on the welfare of the people as well as given to people themselves. He further wrote that if a policy of full employment requires high MPC; then, a progressive taxation like Zakah could help in boosting aggregate demand and increasing employment.

Elaborating the legal importance of Zakah, Liam (2002) reasoned that property rights are valid in a post-tax environment i.e. one obtains the right to own property in the eyes of law when one pays the taxes due. Consistent with logic and this economic philosophy, property rights in Islam are also valid in a post-

Zakah context.

Discussing modern day problems in estimation of Zakah, Usmani (2003) asserted that Zakah on shares would be paid on net liquid assets/share i.e. by excluding from the total assets, the value of assets used as means of production. From the resultant, the liabilities owed to the business are deductible. Then, the Zakah can be paid on the value of net liquid assets/share multiplied by number of shares held by the investor.

Next, we give a brief account of literature review on the institution of Zakah in Caliphates' times. Kuran (2003) identified that the application of Zakah was never uniform even in the period of Prophet Muhammad (P.B.U.H) and pious Caliphates (rta). In Umer (rta) and Abu Bakar (rta) period, Zakah was collected by the government, but, in Usman (rta) period, people were allowed to pay Zakah privately. Horses were exempt from Zakah in Prophet's time, but, Umer (rta) brought it in the Zakah net in His period. Similarly, Mahmud (2001) argued that institution of Zakah is flexible to a certain degree as Umer (rta) levied Zakah on horses and skins and at the time when Arab was hit with a drought and famine, he exempted poor from Zakah and suspended Zakah from the rich.

The collection of Zakah was centralized initially and then it was decentralized in the period of Usman (rta). Usman (rta) also levied Zakah on the production in forests (Nadvi, 1996). It has to be appreciated here that such modifications point to the flexibility that one can use to maximize the benefits of Zakah system rather than pointing to inefficiency or non-uniformity in the system. This flexibility makes the system more adaptable and applicable than rigid with limited scope for flexibility.

Kuran (2006) in another work stated that since traditional understanding on Zakah excludes industrial production and services sector from the net of Zakah, it can hardly achieve anything substantial from agriculture sector. His arguments are noteworthy as the share of agriculture in GDP is declining in developed as well as developing countries and it is a sector with huge documentation problems in developing countries. He also mentioned that Zakah rates are very low to have any impact i.e. 2.5% to 20%. He also identified few anomalies in the Zakah system. For instance, the trader has to pay Zakah on tradable inventory, but the manufacturer is exempt from paying Zakah on means of production. Furthermore, minerals like gold and silver are taxed at 2.5%, while other minerals are taxed at 20%.

It is to be noted that the amount on which tax is levied is more important than the tax rate. A small percentage levied on a gross income would still ensure substantial revenue. Government would have the flexibility to allow certain deductions and not allow others. Furthermore, tax coverage, if comprehensive with low exemption amount would still result in substantial aggregate tax revenue even if marginal tax revenue from individual units (corporations as well as natural persons) is low.

Another anomaly identified by Farooq (2008) in the institution of Zakah and its common understanding is that people in livestock/dairy industry are needed to pay Zakah on cows, goats etc which are means of production for them. But, means of production in other industries are exempt from Zakah. He also stated that in Umer (rta) period, poverty diminished, but, in that period, the ground breaking conquests brought huge resources at the disposal of the then government. Such a thing can hardly happen nowadays.

On the economics of a wealth tax, Moore (2006) disclosed that in France, the solidarity tax has caused capital flight to more wealth-friendly nations. Heckly (2004) insisted that in the current environment, capital and individuals are both highly mobile, countries are working to implement active social policies, without sending capital and the wealthiest taxpayers on the run. That is the reason why, several European countries are now discontinuing wealth tax.

This led some economists to raise questions as to how public finance would work in an Islamic economy. Some studies have shown concern over the applicability of Islamic finance principles beyond the commercial banking into the pricing of loans between countries and IFIs (Reddy, 2001) and monetizing public debt (Darrat & Bashir, 2000). In this regard, Usmani (2003) proposed issuance of GDP growth linked instruments to finance public debt.

Up to now, we have quoted those Muslim scholars who maintained that taxes can be imposed for running the affairs of the state other than Zakah and it is not the mandate of Zakah to fulfill that fiscal need.

On the other hand, Kahf (1987) tracing the history of public finance during Prophet's and Caliphate's times opined that neither the Prophet Muhammad (P.B.U.H) nor the pious Caliphates (rta) levied any tax other than Zakah even when they were aware of the taxes imposed by neighboring non-Muslim countries on their citizens. Saleem (1992) pointed three narrations of the Prophet explaining that the government cannot levy any tax other than Zakah.

The narrations of the Prophet explaining this rule are mentioned below:

- a) There is no [legal] share [for the society] in the wealth [of people] except Zakah." (Ibni Maajah: Kitab-uz-Zakah).
- b) "After you have paid the Zakah of your wealth, you have paid [all] that was [legally] required of you." (Ibni Maajah: Kitab-uz-Zakah).
- c) "No tax-imposer shall enter paradise." (Abu-Daud: Kitab-ul-Khiraj).

Thus far, we have discussed issues related to Zakah which is one important and unique institution available to economic managers in an Islamic economy; Next, we discuss other alternatives for finance in an Islamic economy.

Haque & Mirakhor (1998) classified government expenditures into i) asset creating and ii) non-asset creating. Non-asset creating activities can be financed through tax revenues. But, in asset creating activities, equity modes of financing can be used whereby financing would be generated by way of an instrument. As per their recommendation, this instrument would be priced using the formula:

$$I = w_1WI + w_2PPI + w_3LSI + w_4ROG$$

Where,

WI = World Index

LSI = Stock Index, a measure of market performance index based on ROE.

PPI = Index representing average returns on commercial participation papers.

ROG = Return on government investments and project.

w_1 , w_2 , w_3 and w_4 are weights assigned to each variable.

However, if the resultant rate is stipulated; then, it would be including opportunity cost. Two mutually exclusive equity financed projects cannot arbitrarily set to have same returns on the basis of opportunity cost.

It can be seen from the literature review that Muslim scholars are divided on the issue of whether taxes beyond Zakat can be levied or not. Basing our analysis on the viewpoint that Zakat is the only tax that can be levied other than activity/performance based duties/charges/fees and reciprocal duties on trade as were levied by Umer (rta), we now turn to present our analysis on tax and non-tax sources of revenue available in an Islamic economy and to what extent these sources identified can meet the requirements of the state.

3. Institution of Zakah: An Important Source of Public Finance in Islamic Economy

Zakah is a religious obligation to pay a part of wealth and income to the government. Nisaab on wealth was basically specified in silver. Following Hadith testify this viewpoint:

"There is no Zakah below five wasaqs of dates; there is no Zakah below five uqiyahs of silver and there is no Zakah below five camels." (Mu'atta Imam Malik, No: 578)

For calculation purposes, people used the cross rate between gold and silver and determined their nisaab in gold as well. This cross rate has changed historically; that is why, we will have to resort to the original base i.e. 612 grams of silver when there is no bimetallic monetary standard in operation. One important implication of this principle is that tax exemption amount in silver is much lower than gold using current cross rate and hence taxable assets will increase in magnitude. Zakah would be levied as per the ceiling rates defined for each category of wealth or production.

The classification is as follows:

- a) 2-½% on cash, wholesale value of held for trade inventory and capital in excess of need payable once a year at a particular set date.
- b) 5% on production using both labor and capital. It is charged at the completion of the production process.
- c) 10% on production using either labor or capital. It is charged at the completion of the production process.
- d) 20% on production using neither labor nor capital. This is applicable on treasure or any other natural gift obtained without using neither labor nor capital.

To estimate Zakah on wealth, the following model is established:

$$ZR = 0.025 [ZA - (MNA \times P_{MNA})]$$

Where

ZR = Potential Aggregate Zakah Revenue

ZA = Potential Aggregate Zakatable Assets

MNA = Minimum Nisab Amount i.e. market value of 612 grams of silver

P_{MNA} = People with Minimum Nisab Amount

Zakatable assets include all assets above the value of nisab except the assets in personal use and means of production. Minimum Nisab Amount is the market value of 612 grams of silver. Population with minimum nisab amount is to be estimated looking at wealth distribution of population.

On the surface, it can be seen that as Zakatable assets increase, Zakah revenue increases. Minimum nisab amount in silver terms would remain constant, but its value in currency would change. But, the effect of inflation would impact almost all endowments of an individual overtime.

4. Issues in Estimation of Zakah

Wealth/Assets subject to Zakah include Cash in hand, Cash in Bank, gold and silver not in daily usage (for women), gold and silver owned by men, held-for trade inventory, property/plot purchased for the purpose of resale.

Production is not limited to agriculture nowadays, but the major part of it is coming from industries as well as services sector. Therefore, industrial production could also be taxed just like agriculture. Services income could also be taxed on the same principle.

Khan (2005) stated that investment in stocks should be interpreted as any other investment with some means of earning income. Stock is a means of earning dividend or capital gains. Just like means of production/income are exempt from Zakah, investment in stocks should be exempted from Wealth Zakah as investment in stocks means that the money is not kept idle rather it is invested and even its value could reduce to zero or increase by a long way theoretically. Therefore, any income arising from investment in stocks i.e. capital gains or dividend must be subject to Income Zakah. Similarly, this argument could be extended to introducing Income Zakah on mutual funds, investment in NSS,

debentures, bonds etc. Furthermore, if land/building/house is leased, the land/building/house becomes the means of earning rent. Hence, income Zakah could also be introduced on rental income on houses, assets, buildings etc.

5. Estimation of Zakah

As can be seen from Table 1, Zakah collection and its disbursement is very low and it has not been able to bring about a major socio-economic change. In FY 2009, approx. PKR 150 Billion were paid by people in Pakistan in charity, 90% of which was for the purpose of paying Zakah. (Dawn, September 07, 2009).

Table 1: Total Zakah Disbursement in FY 2007-08

(Rs. Million)

	Punjab	Sindh	NWFP	Balochistan	ICT	Northern Areas
Regular Zakat Programmes	1857	395	411	41	23	38
Total beneficiaries	995	205	94.175	31	12	32
Other Zakat Programmes	738	16	148.881	5	3	5
Total beneficiaries	288	38	69.868	9	5	10
National Level Schemes	196	83	62.527	30	35	0
Total beneficiaries	93	60	31.071	19	14	0
Total amount disbursed	2791	495	623	77	61	43
Total beneficiaries	1376	304	195	59	31	42
Grand Total Amount Disbursed (Rs. Million):	4090					
Grand Total Beneficiaries (Rs. Thousand):	2007					

Source: Ministry of Religious Affairs Zakat and Ushr.

Going into estimation of potential Zakah from agriculture produce, we first present some data that gives us an idea of how much Zakah could be collected both with present production and with enhanced production due to efficient utilization of land. It can be seen from the following data that 9.13 million hectares are unutilized cultivable land in Pakistan. If agriculture's share is 21% of GDP utilizing 22.76 million hectares, an addition in production through utilization of that idle farm land can be computed assuming constant returns to scale on average.

Table 2: Land Utilization (Million Hectares)

Fiscal Year	Total Area	Reported Area	Forest Area	Not Available for Cultivation	Culturable Waste	Current Fallow	Net Area Sown	Total Area Cultivated (1+8)	Area Sown More Than Once	Total Cropped Area (8+10)
1	2	3	4	5	6	7	8	9	10	11
90-91	79.61	57.61	3.46	24.34	8.85	4.85	16.11	20.96	5.71	21.82
91-92	79.61	57.87	3.47	24.48	8.86	4.87	16.19	21.06	5.53	21.72
92-93	79.61	58.06	3.48	24.35	8.83	4.95	16.45	21.40	5.99	22.44
93-94	79.61	58.13	3.45	24.43	8.74	5.29	16.22	21.51	5.65	21.87
94-95	79.61	58.50	3.60	24.44	8.91	5.42	16.13	21.55	6.01	22.14
95-96	79.61	58.51	3.61	24.35	8.87	5.18	16.49	21.68	6.10	22.59
96-97	79.61	59.23	3.58	24.61	9.06	5.48	16.50	21.98	6.23	22.73
97-98	79.61	59.32	3.60	24.61	9.15	5.48	16.48	21.96	6.56	23.04
98-99	79.61	59.28	3.50	24.52	9.23	5.35	16.58	21.93	6.28	22.86
99-00	79.61	59.28	3.66	24.50	9.13	5.67	16.32	21.99	6.44	22.76
00-01	79.61	59.28	3.66	24.50	9.13	5.67	16.32	21.99	6.44	22.76

Source: Ministry of Food, Agriculture & Livestock

Constant returns to scale are assumed as the GoP is planning to lease this unutilized farmland to Middle East and European investors whose involvement is expected to increase productivity. Their interest in agriculture to achieve food security is evident from the Figure 1 given below:



Figure 1: Farm Race

Yu-Hung (1996) revealed that Hong Kong Government captured about 39 percent of the land-value increments occurring between 1970 and 1991 from land leased in the 1970s. More important, the captured value financed 55 percent of the average annual infrastructure investment between 1970 and 1991. These findings indicate that land leasing can be an important source of public funds.

Next, we move to estimate potential Zakah from individuals on their wealth including Cash in bank, investments in Shares, NSS, gold deposits etc.

5.1 Calculation of Nisab for Individuals (Exemption Amount)

Price of Silver (per oz.)	=	USD 15 (1 oz. = 28.34 grams)
Nisab in (oz.)	=	612/28.34 = 21.60 oz.
Nisab value in USD	=	21.60 x 15 = USD 324
Nisab value in PKR	=	324 x 85 = PKR 27,540

5.2 Zakatable Assets

5.2.1 Bank Deposit

Proxy of Measurement:	Total Banking Deposits (Rs.)
Data Source:	Weekly Profile of Broad Money, SBP, March 2010
Total Banking Deposit (Rs.):	PKR 5,137.219 Billion
Gross Zakatable Value:	2.5% x PKR 5,137.219 Billion
Gross Zakatable Value:	PKR 128.430 Billion

However, total banking deposits include the money multiplier effect. The total currency in circulation is less than total banking deposits. If we take the total currency in circulation as the base for Zakah on Cash/currency, we have the following details.

5.2.2 Currency in Circulation

Proxy of Measurement:	Total Currency in Circulation in FY10 (Rs.)
Data Source:	Weekly Profile of Broad Money, SBP, March 2010
Total Banking Deposit (Rs.):	PKR 1,152.173 Billion
Gross Zakatable Value:	2.5% x PKR 1,152.173 Billion
Gross Zakatable Value:	PKR 28.804 Billion

5.2.3 Import Duty

Proxy of Measurement:	Total Imports in 2008/09
Data Source:	FBS
Imports (USD):	USD 34.822 Billion
Rationale for Levy:	Umar (rta) imposed it 10%; so leviable. ¹
Gross Zakatable Value:	10% x PKR 2.96 Trillion = PKR 296 Billion

5.2.4 Gold

Proxy of Measurement:	Gold in Private Hands
Data Source:	World Gold Council
Total Gold Deposit in Pakistan:	65.4 Tons
Gold Deposit at SBP (Rs.):	PKR 157.544 Billion ²
Price of 10g Gold:	PKR 30,000
Price of 1Kg Gold:	PKR 3 Million
Value of Total Gold Deposit:	PKR 196.2 Billion
Value of Total Gold Deposit held Privately:	PKR 38.656 Billion
Gross Zakatable Value:	2.5% x PKR 38.656 Billion
Gross Zakatable Value:	PKR 0.96 Billion

5.2.5 Agricultural Income/Produce

Proxy of Measurement:	Agricultural Income's share in GDP
Data Source:	Budget Report FY08/09, FBS, CBR
GDP (Rs.):	PKR 14,972 Billion
Agricultural Income:	21% x PKR 14,972 Billion=PKR 3144 B
Zakat Rate Used:	80% land is irrigated & 20% land is rain-fed
Gross Zakatable Value:	$0.8 \times 0.05 \times 3144 + 0.2 \times 0.1 \times 3144 = 189 \text{ B}$
Additional Farm Income with farm-lease:	$(9.13/22.76) \times 3144 = 1,261 \text{ Billion}$
Additional Zakatable Value:	$0.05 \times 1,261 = 63.05 \text{ Billion}$
Total Zakatable Value from Farm Income:	252 Billion

5.2.6 Services Income

Proxy of Measurement:	Services sector's share in GDP
Data Source:	Budget Report FY08/09, FBS, CBR
GDP (Rs.):	PKR 14,972 Billion
Services Sector Income:	53% x PKR 14,972 Billion=PKR 7935 B
Gross Zakatable Value:	$0.1 \times 7935 = 793.5 \text{ B}$

5.2.7 Industrial Income³

Proxy of Measurement:	Industrial sector's share in GDP
Data Source:	Budget Report FY08/09, FBS, CBR
GDP (Rs.):	PKR 14,972 Billion
Industrial Sector Income:	26% x PKR 14,972 Billion=PKR 3893 B
Gross Zakatable Value:	$0.1 \times 3893 = 389.3 \text{ B}$

¹ Umar (rta) levied import duty on foreign goods imported into the Islamic state.

² As on June 2009 (Source: Analytical Accounts, State Bank of Pakistan).

³ The tax would be levied as a VAT (Value Added Tax).

Next, we have to make an estimate of how many people have the wealth from various sources mentioned above exceeding Nisab Amount. For instance, if we assume that 10 million people in Pakistan have the wealth exceeding Nisab amount; then:

$$P_{MNA} = 10,000,000$$

$$P_{MNA} = 10,000,000$$

$$MNA = \text{PKR } 27,540 \text{ (as calculated above)}$$

$$ZA = \text{Total Currency in Circulation} + \text{Total Gold in Private Hands}$$

$$ZA = 1,152.173 \text{ Billion} + 65.2 \text{ Billion} = 1217.373 \text{ Billion}$$

From ZA, we deduct the product $[P_{MNA} \times MNA]$,

$$P_{MNA} \times MNA = 275.4 \text{ Billion}$$

$$NZA = 1217.373 - 275.4$$

$$NZA = 941.973 \text{ Billion}$$

We formulated the equation to estimate Zakat as follows:

$$ZR = 0.025 [ZA - (MNA \times P_{MNA})]$$

$$ZR = 0.025 \times [941.973] \text{ Billion}$$

$$ZR = 23.55 \text{ Billion}$$

Total Potential of Zakat from wealth	= 23.55	Billion
Total Potential of Tax from Import Duty	= 296	Billion
Total Potential of Zakat from Agriculture Produce	= 252	Billion
Total Potential of Zakat from Services Sector Produce	= 793.5	Billion
Total Potential of Zakat from Industrial Produce	= <u>389.3</u>	<u>Billion</u>
Total Potential of Zakat & Import Duty	= 1754.35	Billion
Total Taxes in FY09 = 1,157 Billion		

$$\text{Zakat/GDP Ratio} = 11.71\%$$

It is to be noted that the estimate has not included Zakah on real estate held for trade and on held-for trade inventory. It could also not include potential Zakah coming from Capital Gains Tax on Real Estate, Stocks and Mutual Fund Units and on lease income. It has also been assumed that total receivable and total liabilities for individuals are same on average. It implies that there is no effect of receivables and payables.

Kahf (1987) mentioned that once the uncle of Prophet Muhammad (P.B.U.H), Abbas (rta) paid Zakah in advance for two years and that was in the knowledge of Prophet Muhammad (P.B.U.H). This provision can greatly facilitate the liquidity and financing needs of the state in an Islamic economy even in modern times.

Other than Zakah, stamp duty can be levied which is a tax on documents before they become legally effective. Toll Tax can also be levied to fund the development of roads and infrastructure. In developing industrial zones, export processing zones and developing necessary infrastructure, the government can charge a licensing fee from the industrialists to fund expenditure on development. Such a tax/fee or charge is not against the Islamic injunctions as it is directly linked with provision of services and performance. It is also effective in funding expenditure on producing public goods as voluntary payments on public goods are economically ineffective. Excise tax on activities and operations creating negative externality can also be levied. This will be a cost paid to the society for meddling with natural environment.

Tax Increment Financing could also be used which is a tool to use future gains in taxes to finance current improvements which will create the conditions for those future gains. Johnson and Mann (2001) explained that when a public project such as a road, school, or hazardous waste cleanup is carried out, there is often an increase in the value of surrounding real estate and new investment. This increased site value and investment sometimes generates increased tax revenues. The increased tax revenues are the "tax increment." Tax Increment Financing dedicates tax increments within a certain defined district to finance debt issued to pay for the project. This tool is widely used in U.S and in Europe.

Adam Smith in his monumental work *"An inquiry into the nature and causes of wealth of nations"* gave cannons of taxation. The proposed Zakah based taxation system goes very well with Adam Smith's cannons of taxation. It has a proportional tax which can be maneuvered to be progressive as well. It does not tax production heavily (i.e. lenient tax rates) which is in line with Smith's assertion that production must not be taxed heavily. It is simple and certain. It is convenient to collect, more so because it is a religious obligation than just involuntary wealth fetching tool. It only taxes those who have ability to pay i.e. it does not tax those who do not reach a minimum threshold of wealth in their hands.

6. Economics of the Proposed Zakah Based Taxation System

6.1 Effects of Proposed Zakah System on Property Market

If the tax (Zakah) program implemented as proposed, there will be a 10% income tax on the proceeds of sale of a property. The tax will be more if the property is kept than when it is sold. This will increase the supply of land that was not presented for sale before. The increase in supply will bring the prices of properties down. Hence, affordable housing and commercial facilities i.e. office premises, factories etc will come in the reach of consumers and commercial enterprises respectively. A simplified model is presented below:

Property value at t_0 : 1,000,000
Property Prices increase at t_1 by 10%: 1,100,000
If property kept at t_1 , 2.5% tax on property: 27,500
If property sold at t_1 , 10% tax on Gain : 10,000
Net Tax Gain: 17,500

If the property owner does not want to sell the asset and use it in future, but still wants to benefit from the fiscal incentive, he can give it on rent. It will be considered an investment and hence instead of wealth tax, 10% income tax will be charged.

Property value at t_0 : 1,000,000
If property given on rent @ 10%/year of property value
If property kept at t_1 , 2.5% tax on property: 25,000
If property rented until t_1 , 10% tax on Rent: 10,000
Net Tax Gain: 15,000

6.2 Effects of Proposed Zakah System on Investment

Private sectors including both local and foreign investors have an essential role to play in achieving the desired growth and development targets. The goal is not only to redistribute the pie, but to increase the pie is well.

The lenient tax rates will decrease the tax expense and free more resources for reinvestment and profit distribution among shareholders i.e. dividend. Lenient tax rates will help increase in the inflow of FDI. This will increase the competition and convert the major oligopolistic industries into more competitive industries.

It can be seen from fiscal models presented above that if any form of wealth i.e. property, fixed asset, cash etc is put into investment, its nature for fiscal treatment changes and tax saving of at least 2.5% results on the gross investment i.e. if there is no income on investment, 2.5% tax saving results and no income tax is paid since there is no income.

6.3 Effects of Proposed Zakah System on Equity Markets

With interest-based deposits discontinued, savers will have to make a choice between keeping their money idle and pay wealth tax or invest it in some asset and pay the tax only on income if it is earned. A simplified model is presented below:

	Value of Stock of Company A at t_0 : 100
	Stock Prices increase at t_1 by 10%: 110
If no investment in stock or other assets	: 2.5
If stock sold at t_1 , 10% tax on Gain on Sale	: 1
	Net Tax Gain: 1.5

If the shareholder does not want to sell the stock, but still wants to benefit from the fiscal incentive, he can keep and pay tax on dividend. Purchase of stocks for capital gain/dividend will be considered an investment and hence instead of wealth tax, 10% income tax will be charged. A simplified model is presented below:

	Value of Stock of Company A at t_0 : 100
	Company A is profitable & pays 10% dividend
If no investment in stock or other assets	: 2.5
If stock kept at t_1 , 10% tax on Dividend	: 1
	Net Tax Gain: 1.5

7. Non-Tax Revenues

Non-Tax Revenue can come from profitable operations of State Owned Enterprises (SOEs). State Owned Enterprises (SOEs) in postal services, railways, airline industry, steel industry, communication industry, public utilities, transportation industry, aviation industry etc can be run effectively and generate profits as they operate in industries which have significant potential for economies of scale, economies of scope and face relatively inelastic demand. With deficit financing not an option available, there will be an automatic check on government to run these State Owned Enterprises (SOEs) effectively and efficiently.

Fines and Penalties is another source through which government will generate funds. Ideally, this is not a source of revenue as the objective of fines and penalties is to enforce law, improve competition and put right market imperfections. But, this will materialize only when the good practices are rewarded and bad practices penalized.

8. Funding Non-Revenue Generating Activities

The real problem arises in funding operations of non-revenue generating activities like the operations of courts and police etc. It is to be noted here that in Muslim societies under the rule of Caliphates, there was no concept of jail which is a later invention. The Islamic punishments like Capital punishment on Murder, Forced Rape etc, monetary fines and physical punishment in extreme cases of stealing, fraud,

robbery etc do not require people to be imprisoned. As a matter of fact, these prisons become the nurseries for bringing societies even more seasoned criminals rather than a place for rehabilitation. Besides the convicted person, the family of the convicted also gets heavily affected by such imprisonment.

Therefore, reforming the penal law based on Islamic principles will significantly reduce expenditure on making, developing and maintaining such prison cells. If we study the judicial system in Caliphates time, the judicial system did not have high cost of advocacy. Infact, there was no concept of 3rd party advocacy as the law of the land was simple and its implementation enforced strictly. The society put huge emphasis on honest testimony. The judicial system was highly centralized and that too in Umar (rta) and Usman (rta) period when the Islamic state was spread all over Arabia and touching North Africa as well as Eastern Europe.

9. Alternative for Public Finance Other Than Zakah

Next, we discuss how the budget deficit could be financed in an Islamic economy. First of all, it is to be noted that sources of revenue (tax and no-tax) will be substantial enough to meet necessary development and non-development expenditure. Furthermore, if true Islamic values are adopted, non-development expenditure in providing perks to the government officials will also reduce.

Looking beyond imposing more taxes, Usmani (2003) proposed issuance of GDP growth linked instruments to finance public debt. In public finance, a Nominal GDP linked bond could be issued.

In public projects valuation, this benchmark rate would be used to find PV of Cash Flows. This would be appropriate due to following:

- i. It will not lead us into falling in time value of money as we are using an enterprise or output related benchmark rather than interest based benchmark.
- ii. The Cash Flows are obtained using equity contractual modes like Mudarabah and Musharakah.
- iii. In this case, we are calculating valuation models for the investor and not for the borrower. Borrower or financee will be obliged to provide the returns based on these valuations. But, the investor can use this “indicative valuation” to rank investment alternatives.

In actual distribution of income between financier and financee, profit sharing ratio would be used and agreed upon at time (t) and applied to the actual gross profit earned by the financee in time period (t+1). In Figure 2, data for the period 1970-2008 for a group of big economies i.e. America, Britain, Canada, China, the euro area, India and Japan is shown on the variables Nominal Interest Rates (t) and Nominal GDP Growth Rate (t-1) since Nominal GDP responds to interest rate changes as it decreases aggregate demand for the subsequent period, a lag variable for GDP i.e. GDP (t-1) is taken.

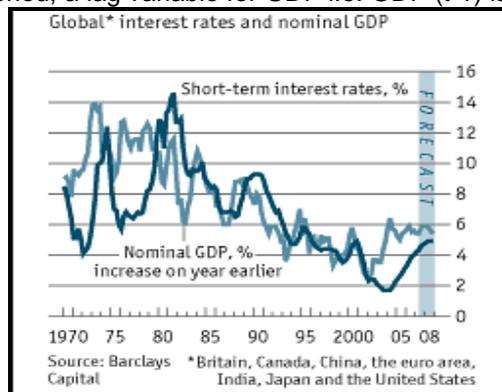


Figure 2: Nominal GDP (t-1) and Nominal Interest Rates (t) for a group of big economies

It can be seen that both variables virtually moved together throughout the period and especially since 1990. Therefore, it is plausible to use Nominal GDP growth rate as the benchmark for pricing instruments in public finance. Since this figure confirms the movement of both variables in the same directions, it can be used for indexing multilateral loans, loans between central banks and between central banks and international financial and development organizations such as IMF, WB, IDA, IDB, ADB etc.

Most developing countries are going through a perpetual debt trap which takes away resources that could have been used on development, but instead are used to service compounded debt. In Figure 3, it is shown that interest payments take up most of the resources of government.

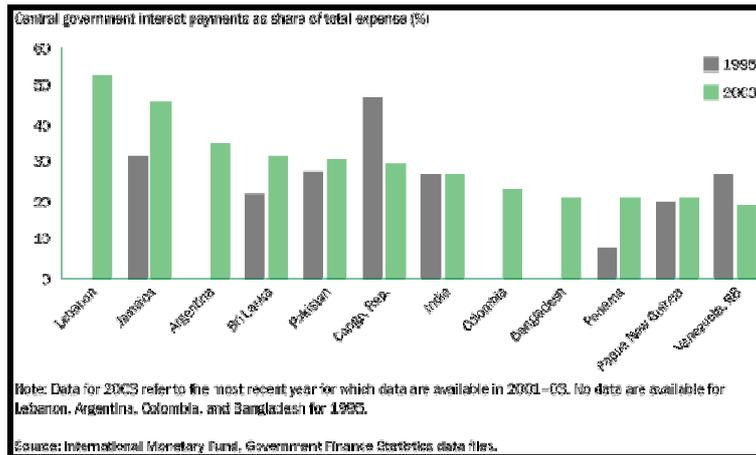


Figure 3: Interest expense as a % of total government's expense

The proposed NGDP linked instrument will not only compensate the financier for parting with liquidity and capital, but also provide a stable mechanism for recipient countries to get out of debt trap with debt servicing linked with output performance benchmark and it will provide relief in the balance of payment and foreign debt management to central banks in developing countries. Second, the government could divest its ownership in State Owned Enterprises (SOEs) or privatize some of them altogether. It could also issue new stocks of State Owned Enterprises (SOEs) and obtain funds for these corporations through primary equity markets.

Conclusion

This study explored the sources of revenue for a government in an Islamic economy. Though Zakah rates are low, but Zakah base is very broad and can include all productive activities. The study also provided brief insights into how much Zakah could be collected in Pakistan and showed that there is ample potential to reach a double digit Zakah to GDP ratio and together with non-tax revenue, the government in an Islamic economy can manage its operations without resorting to interest based deficit financing. This study also discussed that the government if needed can finance its deficit by using nominal GDP growth linked rate of return as a benchmark for domestic and external loans including those from IMF, WB and IDA etc.

Appendix 1: Akram Khan's Comment on A. Azim Islahi & M. Obaidullah: Zakah on Stocks

The paper has taken the existing discussion on the subject a step further. However, to my mind, the entire discussion on the subject is somewhat misplaced. It has generated out of a segmented approach to the subject of Zakah law and Zakah accounting. A different approach would not even raise the questions that are being discussed in this paper and elsewhere in the literature. The whole problem emanates from the first assumption: treating investment in shares as stock in trade. See how this assumption may not be realistic or at least problematic. Suppose two persons have one million dollars each. Both of them buy shares of a company with that money. One intends to keep that investment over a long period and the other has bought these shares for the purpose of selling when the market is favorable. According to the paper under review, we cannot treat both of them alike.

For this purpose, we would need to know the intention of each one of them. In accounting matters, such a situation could be problematic and nothing can be calculated on the basis of invisible intentions. Instead, let us take another route to the problem. We treat all investment in shares as investment. We need not distinguish between investment in sole proprietorship, partnership, joint stock company, for services or for manufacturing, etc. An investment in business is investment, irrespective of the nature of the business.

All wealth can be divided into two types: (a) liquid cash not invested anywhere, kept in bank, locker or in personal wallet. This is unproductive and idle wealth. (b) The other is investment in an asset. The asset could be for personal use such as a house, a car or a machine, etc. It could be for gaining profit in whatever form. The Zakah accounting should follow consistent rules in all situations.

The Zakah on idle cash would be levied at 2.5% of the value. This is straightforward and requires no discussion. The investment of wealth in assets of personal use is exempt from Zakah by a consensus. The Zakah on business investment requires discussion, however. For the sake of consistency, we should take a lead from those cases in which there is a consensus. For example, in case of agricultural produce, there is no Zakah or *Ushr* on the capital value of land by a consensus. It is the produce of land that is subject to *Zakah* @ 5% or 10%, depending upon whether it is irrigated or fed by rainfall. Similarly, if a person has let out a house, there is no *Zakah* on capital value of the house. The *Zakah* is payable on income of the house @ 5% or 10%. If you are operating a taxi, there is no *Zakah* on capital value of the car. The *Zakah* is payable on the rental income @ 5% or 10%. The question arises: If there is no *Zakah* on capital invested in land, house or car, why should it be payable if the money is invested in shares of a company?

The anomaly becomes obvious if we imagine two persons each having one million dollars. One invests in a business (buys shares), the other buys a building for leasing and earning through rental income. If we tax the capital value of the shares and do not tax the capital value of the house, we are introducing an anomaly. Instead, if we tax the dividend income of the one and rental income of the other, we shall be consistent. In brief, we should not worry about the valuation and other related question of the share capital. The *Zakah* is payable on the income from business, and capital remains exempt so far it is invested. It would be subject to *Zakah* if it were lying idle for a year or more.

The question would arise: what if a person invests in shares for a short while and keeps on rotating his capital in buying and selling of shares and he never earns any dividend? The answer is: In that case, each time he buys or sells shares, he would be making some financial gain or loss. At the year-end, all these gains and losses would be net off and if there is a net gain, he pays *Zakah* @10% on the net gain. The capital would remain exempt until it is included in the idle cash and remains sitting there for a year.

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