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**An Alternate Approach to Theory of Taxation and Sources of Public Finance  
in an Interest Free Economy**

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# **An Alternate Approach to Theory of Taxation and Sources of Public Finance in an Interest Free Economy**

## **Abstract**

*This unique study discusses the theory of taxation in Islam and the role of Zakat in an Islamic economy. Zakat is a compulsory payment i.e. a tax in this sense paid to the government on one's income and wealth. The Zakat rates are studied for their viability and effectiveness to fulfill fiscal needs of the government. Based on the evidence from many countries, it is argued that Zakat rates are substantial enough to generate the needed public finance given the large tax base and free the government from using seignorage and deficit financing. Its compulsory nature both as per law of the land and as per religion would ensure minimum tax evasion and its progressive and direct nature would effectively redistribute income. The effect of Zakat on the overall macroeconomy, the financial system, monetary system, property market, stock market, inflation, foreign debt, balance of payments, FDI and the on the development oriented variables like inequality and poverty are also discussed to give a holistic view of the effects of the proposed system.*

**Keywords:** *Interest free economy, Public finance, Taxation, Inequality, Income redistribution, Islamic Economic System, fiscal policy, deficit financing.*

## **1. Introduction**

Zakah is a religious obligation to pay a part of wealth and income to the government. However, in most countries, Zakah is not collected by the government and is not considered a compulsory payment (Powell, n.d). Respected Muslim scholar Ab-ul-ala Maududi reasoned (1970) that Zakah is a religious obligation and is not a substitute of tax. Taxes other than Zakah can be imposed in an interest free 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. Rehman (2006) also asserted that Zakah is not the same as taxes as the former is paid by the individuals to purify one's income and wealth based on the direction of Allah and the later is usually imposed by government for running its affairs of the state. Islahi (1985) 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.

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. The sanctity of property rights is conditional to paying taxes. Consistent with logic and this economic philosophy, property rights in Islam are also valid in a post-Zakah context.

The respected Muslim scholar Muhammad Taqi Usmani (2009) arguing in favor of limited liability used the argument that a judicial person can have separate existence and thereby practically granting and reaching the same result as that of Islahi's work on Tamlik, but the arguments of both are different since Islahi's work is not based on logic alone, but on Quranic Arabic.

Hashmi (2002) explained Islahi's viewpoint on 'Tamlik'. In the following lines, a summary of Islahi's viewpoint as explained by Hashmi from Islahi's original work in Urdu is presented.

Literally, tamlik means 'to put somebody in possession of something'. Here, with reference to Zakāh, it means 'the transfer of ownership of Zakāh money to the real beneficiary'. Our scholars regard it necessary to transfer the ownership of Zakāh fund to a needy person. Therefore, the money of Zakāh

cannot be spent for general welfare of the poor. For example, we cannot build hospitals for the free treatment of the poor, cannot establish schools for their children, and cannot provide their dwellings with fresh water. Likewise, we cannot arrange for the burial of a poor person or pay loans outstanding against him, for he cannot be made the owner of the money in person.

Those who consider tamlik compulsory for the payment of Zakāh put forward the following arguments:

1. In the Qur'ānic verse '...إِنَّمَا الصَّدَقَاتُ لِلْفُقَرَاءِ' (Indeed, the alms are for the poor... (9:60), the preposition 'lam' is for tamlik.
2. The word ltā (giving) in 'آتُوا الزَّكَاةَ' (pay Zakāh) connotes the meaning of tamlik.
3. The Qur'ān uses the word Sadaqah for Zakāh and tasadduq (give in charity) originally implies tamlik.

Amīn Ahsan Islāhī, a distinguished religious scholar has effectively refuted these arguments in his book 'Masa'alah-i-Tamlik'. His viewpoint in response to the first argument of the said school is as follows:

1. There is no clear instruction in the Qur'ān and Sunnah which says that tamlik is an indivisible condition of Zakāh.
2. The preposition lām (ل) in the word 'لِلْفُقَرَاءِ', is not merely used for tamlik in the Holy Qur'ān rather it connotes a host of meanings. Ibn Hishām, a renowned grammarian of the Arabic language, has enumerated nearly twenty-two usages of this preposition in his celebrated treatise 'Mughnī al-Labīb'. Some of them are:
  - a) Istihqāq: 'to merit, to deserve', as in 'الْحَمْدُ لِلَّهِ' (All gratitude is due only to Allah.)
  - b) Ikhtisās: 'to be exclusively for', as in 'لِلْمُؤْمِنِينَ الْجَنَّةُ' (Paradise is exclusively for the believers.)
  - c) Milkiyyah: 'to own something', as in 'لَهُ مَا فِي السَّمَوَاتِ وَمَا فِي الْأَرْضِ' (His is what is found in the heaven and what is in the earth.)
  - d) Tamlik: 'to make someone owner of something', as in 'وَهَبْتُ لِذَيْدٍ دِينَارًا' (I made Zayd owner of a dinār.)
  - e) 'Āqibah: 'to be ultimately for', as in 'فَالْتَقَتْهُ آلُ فِرْعَوْنَ لِيَكُونَ لَهُمْ عَدُوًّا وَحَرِيمًا' (Then Pharaoh's household picked him up so that he may become their enemy and cause of grief for them.)

It is worth mentioning that Ibn Hishām has cited examples mostly from the Holy Qur'ān. For tamlik, he has cited a common expression of the Arabic language. Had the meaning of tamlik been so pronounced in the lām used in '...إِنَّمَا الصَّدَقَاتُ لِلْفُقَرَاءِ', he would have quoted it as an example.

3. Muslim jurists and scholars do not agree upon one meaning of this lam. The Hanafites take it for 'āqibah (consequence) whereas the Malikites take it for tamlik.
4. The context of the verse does not allow this sense of the preposition. Following is the context in which the verse occurs:

Among these hypocrites are people who level allegations against you concerning the distribution of alms. If they are given according to their wishes, they are pleased. If they are given nothing, they grow resentful. It would have been better if they were satisfied with what God and His Prophet have given them, and said: 'God is sufficient for us. He will provide for us from His own abundance and so will his Messenger. To God we will submit.' Alms shall be only for the poor and the destitute; for those that are engaged in the management of alms and those whose hearts are to be won in favour of Faith; for the freeing of slaves and debtors: for the advancement of God's cause; and for the traveler. That is a duty enjoined by God. God is all-knowing and wise. (9:58-60).

Amīn Ahsan Islāhī's explanation of the context of these verses is as follows:

These verses portray the picture of the hypocrites whose response to the Prophet was conditional upon their self-interest. If they were given what they wished, they would remain pleased; otherwise, they would get annoyed and accuse the Prophet of partiality and favoritism. And they would spread such depraved thoughts among Muslims. Now consider what needs to be made clear. Does the situation need a statement making transfer of Zakāh fund directly to the recipients compulsory or the explanation that alms are only meant for such and such people?

5. The construction of the verse does not accept the meaning of tamlik. In Islāhī's own words:

In the verse, it is obvious, there are eight things mentioned as the lawful use of the Zakāh fund. Of these, four come under influence of the preposition lām and the remaining four come under the preposition fī. We must construe something corresponding with both the prepositions lām and fī. If we take lām in the meaning of tamlik, the first part of the sentence is separated from the rest, as fī does not imply the meaning of tamlik at all. It only connotes the meaning of 'usefulness' or 'service' as it does in the following narrative of the Holy Prophet: 'مَا كَانَ الْعَبْدُ فِي عَوْنِ أَخِيهِ' (until one remains in the service of his brothers). Therefore, a compact and well-knit structure of the verse, like this, demands that the both lām and fī imply the meaning of 'deserving' or 'benefiting from' so that the verse may be interpreted giving an intelligible set of meanings. To take the lām in the sense of tamlik would not be possible without sacrificing the eloquent expression of the Qur'ān.

As regards the second and third argument, it is correct that sometimes itā and tasadduq connote the sense of tamlik, but the ultimate interpretation rests on the context of the usage. It does not serve as a stance to prove that the meaning of tamlik is inseparable in this lām. Had it be the case, we would have taken this meaning in the sentences 'وَأَتَيْنَاهُمُ الْكِتَابَ' (and we gave him the book) and 'وَأَتَيْنَا دَاوُدَ زَبُورًا' (and we bestowed upon David Zabūr), which of course would be wrong. Likewise, the verse 'فَأَصَّدَّقَ وَأَكُنْ مِنَ الصَّالِحِينَ' (so I would give in charity and be among the pious ones) means 'I would spend in the way of Allah and would spend my money for the benefit of the poor'. It does not mean at all that I would transfer money in the possession of the poor.

Islāhī elucidates this aspect in the following words:

The meaning of tamlik is not manifest in the words itā and tasadduq. Therefore, it cannot be presented as the final proof in favour of the concept of tamlik. The only thing these words represent is giving or spending. It can be done by transferring the ownership of the money to a poor or spending it for the betterment of the poor community.

It is clear from above explanation that it is not necessary to make some living person an owner of the proceeds of Zakah.

Ghamidi (2007) in his monumental book 'Meezan' has argued that no tax can be levied other than Zakah. Further, concept of 'Ushr' can be applied in industrial production as well on the premise that rain fed land was taxed at 10% and irrigated land was taxed at 5%. Based on this argument, he deduced that rain fed land use primarily labor as a factor of production; whereas, irrigated land use both labor and capital. Thus, industries employing both labor and capital can be taxed at 5% and those employing only labor or capital can be taxed at 10%.

Furthermore, Ghamidi (2007) argued that since stock-in-trade is exempted from Zakah, it can be deduced from this principle that investments made for earning profits can also be exempted from Zakah and only income from such investments would be taxable at 10% since no labor is usually involved when one purchases a share or equity stake in a business concern. However, Usmani (2003) asserted that Zakat on shares would be paid by excluding from the total assets the value of operational assets such as plant and machinery i.e. those coming under the ambit of means of production. From the resultant, the liabilities owed to the business can be deducted. Then, the Zakat can be paid on the value of those assets arrived as a resultant of two adjustments based on the proportional ownership of the investor in that business.

As discussed before, most Muslim scholars maintained that Zakat is not the only form of revenue for government generated from public's income and wealth and secondly, taxes can be imposed for running the affairs of the state other than Zakat and it is not the mandate of Zakat to fulfill that fiscal need.

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 backdrop, this study extending on the work of Ghamidi (2007) takes an alternative approach to theory of taxation in Islam and sources of public finance available in an interest free economy acknowledging that Zakat is the only form of compulsory taxation available to the government in an Islamic economy. This study proposes analogical deduction to make principles work effectively keeping in view the contemporary advancement in civilization and economic relationships.

## **2. Heads of Zakah**

*"Alms are for the poor and needy, and those employed to administer the funds; for those whose hearts have been (recently) reconciled (to truth); for those in bondage and in debt; in the cause of Allah; and for wayfarer; (thus it is) ordained by Allah, and Allah is full of knowledge and wisdom (Al-Tauba: 60)".*

Zakah is paid to and can be utilized by the government in following areas:

1. Poor and needy.
2. Paying salaries to government employees.
3. Muslims who have recently come into the fold of Islam, incurring political expenditures on foreign relations, domestic relations and appeasing those who by way of receiving Zakah refrain from posing threat to the Islamic state.
4. Free those in bondage. Nowadays, paying penalty on someone's behalf if need and situation demands.
5. Compensate debtors who are in trouble.
6. In the way of Allah (e.g. defense expenditure etc).
7. For making rest houses, roads and bridges for travelers etc.

## **3. Fiscal Principles**

The following four fiscal principles are the basis of fiscal reforms:

1. Rates of Zakah.
2. Zakah rates are ceiling rates.
3. No tax can be levied other than collecting Zakah.
4. Zakah is payable to the government.

### **3.1 Rates of Zakah**

Nisaab implies the amount of wealth, production or livestock, which is exempt from *Zakah*. The *Nisaab* (minimum exemption limit) for *Zakah* is as follows:

- a) In case of wealth, 612 grams of silver or equivalent in value.
- b) In case of production, 1,119 kilograms of average quality dates or equivalent in value.
- c) In case of livestock, 5 camels, 30 cows or 40 goats or equivalent in value.

Nisaab on wealth was basically specified in silver. 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. 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. If the wealth, production or livestock exceeds the minimum exemption limit, Zakah would be levied as per the ceiling rates defined for each category of wealth or production.

It is generally understood that Zakah is only 2-½% on capital. But rates of Zakah are different on various heads of income. Agriculture economy existed 1400 years ago. If there was Zakah on agricultural produce, there should be Zakah on industrial produce if it exists today. Ushr and Khums was in principle a production tax. It should be imposed today on all heads of income and 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. Diamond and precious stones should be taxable as Zakah is paid out of wealth and all that constitute wealth should be taxable. Property/Vehicle & other assets used for personal consumption beyond a limit (in excess of need) should also be taxable.

b) 5% on production using both labor and capital. It is applicable on production in industries and agriculture or on any other income earned where both labor and capital are utilized. It is charged at the completion of the production process.

c) 10% on production using either labor or capital. It is applicable on rental income, dividend income, income from selling securities yielding capital gains, salaries and pure service industries such as consultancy. It is charged as soon as the income is realized.

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.

Production is not limited to agriculture nowadays, but major part of it is coming from industries. Therefore, Nisaab for industrial production will have to be defined for the first time. As discussed above, Nisaab implies the minimum exemption amount; it can be increased as well as defined afresh on new assets, production or income added into the tax net over time.

### **3.2 Zakah Rates Are Ceiling Rates**

Ghamidi (2007) has argued in his research that the rates on Zakah are ceiling rates. This is discovered by looking at the linguistic construction of that said directive. This paper will not go into details about the linguistic construction but one can refer to his work for further research. It implies that government cannot charge anything above these rates on the particular heads of income as specified above. But, the government can charge a rate below these ceiling rates. The government can give a tax benefit for a particular social purpose to any industry, group of people and socio-economic activity. The Prophet Muhammad (Peace Be Upon Him) gave tax exemption to vegetables, horses etc.

In pure service industries like consultancy service, services of doctors and lawyers etc, a rate of 10% Zakah can be charged. When a particular industry moves away from a pure service industry to a producing industry; the rate of Zakah can be decreased up to not less than 5%. Between the service and goods producing industry, tax can be levied within the range of 5% and 10%. The industries in which producers have producer surplus should be taxed a little heavily in the defined range.

### **3.3 Zakah Is Payable To The Government**

Zakah is payable to the government. It is declared as a right of the government and the duty of citizens towards the government. Only when the government is not collecting Zakah, one can pay it privately. But if the government collects Zakah in a community, people must pay it to the government.

### **3.4 No Tax Levitation Other Than Zakah**

The government cannot levy any tax other than Zakah. This will serve as an automatic check on the government to effectively and efficiently collect and spend the proceeds of Zakah.

Saleem (1992) has pointed three narrations of the Prophet explaining this rule.

- 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).

### **4. Economic Results of Islamic Fiscal Reforms**

1. Gap between the rich and poor will decrease. Expansion by way of functional inequality can very easily lead to inflation and further worsen the distribution of income, wealth and resources. Expansion in production and investment influenced by fiscal incentives complimented by monetary discipline (stable exchange rates than currency depreciation-inflation spiral and doing away with increasing money supply) can redistribute resources in a better way and pave way for a stable and growing economy.
2. It is a progressive system of taxation. A wealth tax would redistribute wealth. Production with intensive mix and use of factors of production (labor and capital) is taxed leniently at 5%. Production with less intensive mix and use of factors of production (labor or capital) is taxed at a minimum of 5% to a maximum of 10%. Windfall gain is taxed at 20% if it arises from neither the use of labor nor capital.
3. It covers all heads of income including service industries, goods producing industries, agricultural income, rental income, personal income, corporate and business profits of proprietors and firms, income on financial instruments like stocks, mutual funds, REITs (both dividend and capital gain included) etc.
4. It levies a special tax on cash, cash equivalents and capital in excess of need that makes sure that the money circulates and is used in the productive activities.
5. Tax on cash and capital will force the people to invest their money in productive uses. With prohibition of interest, this money will only go in business either with the start of one's own business or equity participation in Mudarabah and stocks etc.
6. It results in an increase in tax base because it covers all heads of income.
7. It simultaneously benefits the taxpayers as the rates in the range of 5% to 10% are very lenient as compared to the current rates in conventional taxation system.
8. Since it is not only a state obligation but a religious obligation, it is hoped that it will not result in tax evasion.
9. It reduces confinement of wealth in few hands. The flow (income) and the stock (wealth) both are taxed.
10. Including the amount of liability and receivables in Zakah accounting would encourage spot and cash transactions whenever possible and decrease the size of credit transactions.



## **5. Fiscal Reforms And The Fiscal Deficit: Case of Pakistan**

Pakistan's fiscal deficit is around 7% of its GDP. The current tax to GDP ratio is approximately 10% of the GDP. It suggests that if tax-to-GDP ratio can be increased to more than 15%, the fiscal deficit will substantially reduce. Zakah at rates of 5% to 10% on all production will result in the tax to GDP ratio of around 8%. Moreover, with the removal of interest expense from the income statement of all enterprises, the taxable income of all enterprises will increase, resulting in an increase in tax collection.

In the system of Zakah, the tax exemption amount is very low on cash and capital in excess of need i.e. 612 gram silver which results in increase in taxable income and tax collection. The 2-½% wealth tax on cash and capital in a country will be adequate enough in attaining the total Zakah/GDP ratio of more than 20%

Moreover, such a lenient taxation structure will itself increase productive activities, employment generation on a large scale and higher tax collection for the government. It will allow the government to allocate more resources on development.

The presence of an active public sector is required to achieve the social targets that cannot be achieved through the private sector. The income from those public enterprises will not only put a check on the private sector but also achieve the social objectives, such as reducing inequality of income. Industry specific studies can be undertaken to determine which industries must be kept in public sector and which must be privatized. Since the fiscal incentives are attractive enough to lure foreign investors, they can be asked to buy at least one loss incurring public enterprise with a cash cow enterprise. A hefty license fee can be charged to generate fiscal space for subsidizing the public sector enterprises and turning them around.

A Natural Monopoly provides an important necessity to masses. We call it natural because of the peculiar nature of that industry which requires heavy capital expenditure. Now, when more firms enter a market, market share gets divided, but not the capital expenditure. For that capital expenditure to be recovered, a firm needs volume and economies of scale. Therefore, market in that situation "naturally" needs to be concentrated.

When a Natural Monopoly is privatized, the market at best can be oligopolistic. There is no problem with oligopolistic markets in usual if the demand for the products is elastic. But, if it is inelastic, as is the case for products of a Natural Monopoly, the oligopoly would run into cartelization or by the application of game theory would again turn into a monopoly. The size of the pie can hardly be increased because the demand is inelastic. Since the demand is inelastic, the decrease in price will decrease revenue and not increase it assuming that the products are not exportable i.e. market size can not be increased.

Therefore, competition in such a market may not depress prices, it will (even if number of firms increase in short run) result in exit of firms to once again make market oligopolistic. But, the market will not be stagnant as an oligopoly as the demand is inelastic, it will either result in cartels or in monopoly after firms try to predict other firms' behavior and make strategic choices. That is why, a Natural Monopoly exists in industries which produce an important necessity, but require heavy capital expenditure.

Privatization of a natural monopoly in "developing countries" raises few questions as in most developed countries; there is less inequality in infrastructure, income, wealth, job opportunities than developing countries in South America, Africa and South Asia. Therefore, in developed countries, the whole operations can be subdivided and sold in pieces to individual companies. But, in a developing country like Pakistan, hardly any body would be willing to buy an electric company in NWFP and Baluchistan where line losses and significantly different infrastructure facilities, law and order situation and dispersed population exists. Therefore, operations of a giant big Monopoly can not be easily divided and sold in pieces. Some can be sold, but not all divisions can be sold. If government takes over those pieces, then it will be more inefficient with less profitable business divisions than having all mixed up in one big

corporation. In addition to that, a Natural Monopoly can adjust losses from one with profits from another division. It can fulfill deficiencies internally. If some divisions remain unsold, the less profitable divisions will have to fill the gap paying the market price than just a mere transfer of shortfall from one division to another as in Natural Monopoly. This will further increase the gap between profitable and less profitable divisions and eventually it will once again become a consolidated industry and may even become a monopoly.

In that case, a Natural Monopoly is better off being in Public ownership and hence the concept 'Public Monopoly'. The only thing forgone is tax revenue. But, it comes if it is profitable. If it is profitable, then, profits do overcome taxes. Tax revenue can not be greater than profits. Further, the government avoids regulation. Moreover, in developing countries, this huge capital expenditure would usually be provided by foreign companies. They can repatriate profits and hence will increase capital flight.

In other cases, we can give private sector the chance to lead the economy. In the proposed model, Defense, Communication, Transport, Education and Health would be run in Public sector as is the case in most other countries too. In other sectors, government can either privatize or give operating rights to private sector and retaining ownership to some extent.

Privatization would increase layoffs and increase structural unemployment. Structural unemployment is classified as natural in Economics. The government is only responsible to avoid cyclical unemployment. Structural unemployment requires education to be in Public sector and subsidized. Scandinavian and many European countries have an efficient public sector education system. It is subsidized and it needs to be subsidized to enable people to change their fortunes after structural unemployment. In the time lag between the change of fortunes, they also need subsidized health facilities and hence health should also be in public sector. Private education system and health can run in tandem with public sector. But, some education and health must exist in public sector.

One possible question may arise here as to how such lenient tax rates would increase revenue. If the government has a fiscal deficit of 7% of GDP when corporate tax rates are 35%; then, how can reducing tax rates increase the revenue?

The answer to this is that higher tax rates discourage entrepreneurship as they decrease the incentive to produce. Lower tax rates encourage entrepreneurship and hence increase the size of producing sector and hence production. With the increase in production, tax revenue in amount increases. Lower tax rates can still ensure high tax to GDP ratio. This is evident from Table 6 which lists countries with corporate tax rates below 20% and their tax to GDP ratio.

S.No.	Country	Tax to GDP Ratio	Corporate Tax Rate
1	Chile	17.1%	17%
2	Bulgaria	34.4%	10%
3	Czech Republic	36.3%	21%
4	Georgia	21.7%	15%
5	Greece	33.5%	22%
6	Hong Kong	12.8%	16.5%
7	Hungary	37.3%	16%
8	Iceland	40.4%	18%
9	Ireland	34%	12.5%
10	Kazakhstan	26.8%	15%
11	Netherlands	39.5%	20%
12	Poland	33.8%	19%
13	Romania	28.1%	16%
14	Russia	36.9%	20%

15	Serbia	34.1%	10%
16	Singapore	13%	17%
17	Slovakia	29.5%	19%
18	Switzerland	30.1%	13%-25%
19	Turkey	32.5%	20%
20	Uzbekistan	21%	12%

Source 1: International Tax & Business Guides- Economic Data – Statistics – Tax – EIU – The Economist  
Source 2: 2009 Index of Economic Freedom – Heritage Foundation

If this system is enforced with utmost sincerity by the government, along with the commitment of the general public and the public/private sector partnership, this can put an end to deficit financing. It will automatically result in price stability and improvements in living standards.

### Effects of Fiscal Policy 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, income tax will be charged. 10% income tax will be charged on rental income.

A simplified model is presented below:

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

### Effects of Fiscal Policy on Investment

Government will not be able to achieve growth all by itself. The fundamental nature of the economy proposed here is modified capitalism with free market principles with social responsibility and ethical checks. Therefore, 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 maximum corporate tax rate ceiling of 10% will decrease the tax expense and free more resources for reinvestment and profit distribution among shareholders i.e. dividend. Since the proposed economic framework is holistic, the monetary policy effect of discontinuing interest-based products will make savers go for equity investments and the whole economy will gradually transform from debt-based financing to equity-based financing.

Dealing with risk averse investors is also a major issue. Here, the credit rating agencies will have a big and active role to play in providing timely information and fact based forecasts. However, what will make it all possible is the massive inflow of FDI<sup>1</sup> because of tax advantage. This will increase the competition and convert the major oligopolistic<sup>2</sup> industries into more competitive industries. Therefore, sectoral diversification will be possible for risk averse investors.

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.

Competition makes the market more efficient than what the government intervention can do. Therefore, provided with fiscal incentives, investment both local and foreign is expected to increase, bringing more employment, making industries competitive and hence more responsive to their stakeholders i.e. customers and shareholders.

### Effect of Fiscal Policy 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	: 2.75
If stock sold at $t_1$ , 10% tax on Gain on Sale	: 1
Net Tax Gain: 1.75	

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, income tax will be charged. 10% income tax will be charged on dividend income. 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	: 2.75
If stock kept at $t_1$ , 10% tax on Dividend	: 1
Net Tax Gain: 1.75	

<sup>1</sup> FDI: Foreign Direct Investment

<sup>2</sup> Oligopolistic markets are markets in which there are few sellers rather than a single seller as in monopoly or many sellers as in perfect competition and monopolistic competition.

## **Effects of Fiscal Policy on Inflation**

The fiscal incentives provided will bring in investment from local as well as foreign investors and the discontinuation of interest based investment avenues will make equity financing by companies possible. Therefore, those commercial enterprises with own funds will come for fiscal incentives and those commercial enterprises with limited internal equity will be able to generate funds through equity financing.

It will transform the oligopolistic markets into competitive markets. Hence, firms will not have much influence to effect prices. Therefore, artificial price increases through collusion and hoarding will not be possible. The other notable driver of inflation is the interest rate. Since the interest will be discontinued, inflation will not be derived from interest. Therefore, inflation will only increase at the natural rate and its effect will not be felt by common person due to direct taxation since there will not be indirect taxes which inflate prices of inelastic goods. Furthermore, increase in investment and new entrants will increase employment opportunities and the per capita income of masses.

## **Providing Interest Free Immediate Income: An Alternative to Subsidies & Transfer Payments**

Interest based system provides immediate, regular and identical income to pensioners, widows, retired and disabled Persons. When interest based system will be discontinued, these people will be at a loss if they are not provided with an alternative that is allowed in Islam yet providing immediate, regular and identical income.

The alternative for this problem is Islamic Income Fund and Real Estate Investment Trust. Islamic Income Fund will derive its income from investment in Ijarah, Diminishing Musharakah and Mudarabah. Islamic Banks provide income to their depositors on the same principle. Islamic Income Fund will be more diversified as it will be able to invest more funds in Islamic Banks with low NPLs and better risk management procedures. Additionally, it will invest some funds in equity markets to provide better returns than standalone Islamic Banks.

Real Estate Investment Trust (REIT) will invest in property market and gain through purchase/sale of properties and rental income. REITs investing funds in properties and giving them on rent will get regular rental income and hence will be able to provide their unit holders' regular source of income.

## **Conclusion**

This unique study discussed the theory of taxation in Islam and the role of Zakat in an Islamic economy. It maintained that Zakat is a compulsory payment i.e. a tax in this sense paid to the government on one's income and wealth. The Zakat rates were studied for their viability and effectiveness to fulfill fiscal needs of the government in general and taking the specific case of Pakistan. Based on the evidence from many countries, it is argued that Zakat rates are substantial enough to generate the needed public finance given the large tax base. Its compulsory nature both as per law of the land and as per religion would ensure minimum tax evasion and its progressive and direct nature would effectively redistribute income. The effect of Zakat on the overall macroeconomy, the financial system, monetary system, property market, stock market, inflation, foreign debt, balance of payments, FDI and the on the development oriented variables like inequality and poverty are also discussed to give a holistic view of the effects of the proposed system.

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