Towards Self-Enforcing Islamic Tax System: 
An Alternative to Current Approaches

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ABSTRACT. In this paper an attempt is made to develop an alternative Islamic approach towards self-enforcing direct tax system. A number of Muslim countries are, at present, economically backward. Here resource mobilization efforts occupy a prime position. Taxation is one of the important means of mobilizing resources. It calls for a self-enforcing tax system which helps not only in raising the required revenue but also minimizes revenue leakage on account of tax evasion. It is defined as the one where efforts to evade one tax will automatically involve the taxpayer in other tax liabilities so great that evasion is not worthwhile. The system makes it to pay to be honest about taxes. Any approach towards a self-enforcing system qualifies itself to be called as the Islamic only when it essentially satisfies two conditions. First, it is necessary that in the perceived approach zakah should form the core of resource mobilization effort. Second, in addition to the current secular rules and regulations regarding rates, exemption levels, administration, etc., the approach should also incorporate minimum of the Shariah prescriptions. On one front of the Islamic approach, as developed in the present paper, zakah occupies a pre-eminent position, on the other front a gross tax on income, an expenditure tax and a withdrawal tax operate to support one another so as to reinforce the system. This approach makes taxpayers to pay at each and every stage of accretion, consumption and accumulation.

A number of Muslim countries, wherein it is possible to create Islamic societies and establish Islamic states, are, at present, characterized by economic backwardness. Even though a few among them are capital surplus countries, it can be said that they, too, are not developed in the real sense of the term(1). If efforts are not made to speedup economic growth then, in the years to come, their economic backwardness would create problems for the Muslim ummah on social, economic and political fronts. Their dependence on developed countries, mainly non-Muslim, would increase to the advantage of the latter.

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(1) One can refer to various issues of World Development Report of the World Bank and Human Development Report of UNDP so as to obtain a clear idea about the present state of economic affairs in Muslim countries.
Given the present day scenario it is necessary for Muslim countries to make sincere efforts to accelerate the rate of economic growth. The path of economic growth is not a smooth one. It involves pains, sacrifices and adjustments of different sorts. Here the resource mobilization effort occupies a prime position. Resources are normally mobilized through tax and non-tax means. On account of the limitation of this paper the non-tax means of revenue are not discussed here. So far as taxes are concerned it is maintained here that not only the rates and number of taxes matter, an effective tax administration is equally important. It helps not only in raising the required revenue but it also minimizes revenue leakage on account of tax evasion. It is here that the need for a self-enforcing tax system arises. This paper attempts to develop outlines of a self-enforcing tax system for Muslim countries. It is organized as under: Section I explains meanings of the self-enforcing tax system. Section II examines certain minimum Shariah prescriptions that impart Islamic character to the proposed self-enforcing tax system. Different constituents of the self-enforcing system are explained in Section III. The final Section contains some concluding observations.

I

The governments in developing countries, in order to raise required revenue, normally impose several types of taxes on individuals, business corporations and commodities. Several tax rates on one hand and poor tax compliance and administration on the other make it possible, and even encourage too, a large-scale tax evasion. Even though currently there is a paradigm shift in favour of market-led growth with governments adopting off-budget measures, the importance of taxation as a means of resource mobilization cannot be denied. Not in all the Muslim countries it can be expected that a recourse to market provides sufficient revenue for the purpose of financing socially welfare-oriented functions of the government. The market failure in the context of provision of public goods is an important part of the debate in area of Public Economics(2).

In developed countries the problem of tax evasion may not be that serious though its existence cannot be denied altogether. Limited possibilities of evasion can be attributed to a practice of book keeping which is normally of a very high order. At the same time there prevails in developed countries a very high sense of tax compliance. Consequently, tax evasion happens to be a very small fraction of tax liabilities of individuals and corporations. This, however, is not so in the case of Muslim countries in particular and other developing countries in general. Here tax evasion is a rule rather than an exception. This phenomenon of evasion not only adversely affects resource mobilization effort but it also makes governments to rely more on non-tax means of revenue such as deficit financing and public borrowing. It is here that the need for a self-enforcing tax system is felt which, on one hand, helps to raise required revenue and, on the other, brings down the existing level of evasion.

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(2) A. B. Atkinson, and J. E. Stiglitz, 
Higgins defines a self-enforcing tax system as the one where efforts to evade one tax will automatically involve the taxpayer in other tax liabilities so great that evasion is not worthwhile. The system makes it to pay to be honest about taxes. At the same time, it has built-in incentive aspects that should contribute to economic growth. This notion of a self-enforcing tax system as defined by Higgins is very close to the idea of “a closed tax system” developed and proposed by Nicholas Kaldor to the Government of India in 1956. The Government of India adopted Kaldor’s report and introduced wealth and expenditure taxes. To this day, the wealth tax exists, the expenditure tax, however, had a chequered history. Of the several reasons attributed to its poor performance, one major reason was that the expenditure tax was not implemented in the form as recommended by Kaldor. At present, a different variant of the expenditure tax is operating.

Higgins admits that Kaldor’s idea of a closed system provided the “missing link”. Higgins borrowed from Kaldor’s famous idea of an expenditure tax. He admits that by adding to Kaldor’s expenditure and wealth taxes, a penal tax on excess inventories and a turnover tax, it is possible to devise a closed system so that any one failing to report one taxable transaction will either find himself paying more under another tax or having the transaction reported by the other party to it because the other party can reduce its liability by honest reporting.

II

Following the above scheme, an attempt is made here to develop an alternative Islamic self-enforcing tax system that can be applied in Muslim countries. Admitting complexities and intricacies that are normally associated with the administration of different taxes, the scope of present paper is limited only to the area of direct taxes only.

We already have two approaches before us. One is that of Higgins’ “self-enforcing tax system” and the other that of Kaldor’s “model of a closed system”. What is then an alternative Islamic approach? Any approach towards a self-enforcing system qualifies itself to be called as the Islamic only when it essentially satisfies two conditions. First, it is necessary that in the perceived approach zakah should form the core of resource mobilization effort. Second, in addition to the current secular rules and regulations regarding rates, exemption levels, administration, etc., the approach should also incorporate minimum of the Shariah prescriptions.

The two minimum requirements as mentioned above make it necessary to understand the importance of zakah and Shariah prescriptions. The importance of zakah is very well documented in the literature on Islamic Economics. It is, therefore, not necessary to repeat the same once again. It suffices here to maintain that Islam institutionalized zakah to ensure that no one suffers for the want of wherewithal to meet

(7) For a discussion on “just tax system from Shariah view point” please refer to M. Umer Chapra, Islam and Economic Challenge, The Islamic Foundation, Leicester, U.K., 1992, pp. 296-97
his or her basic needs. “It is, thus, the financial embodiment of an indispensable socio-economic commitment of Muslims to meet the needs of all without putting entire burden on the public exchequer which socialist and secular welfare states have unwittingly done”(8).

In Muslim countries the choice of a tax or a combination of taxes, level of exemption, rate bands, scope for deductions and definition and measurement of tax bases, etc., need to be greatly guided by the dictates of Shariah. A study of administration of zakah and kharaj during the period of the Prophet and his righteous caliphs would be of immense significance. It provides us with a set of Shariah principles. The levy of zakah, itself, for example, sets certain imperatives as follows:(9)

First, no additional levies on personal or collective incomes can be imposed on assets whose incomes fall below the nisab stipulated in zakah.

Second, in the calculation of assessable income, expense items shall have to be deducted as are done under zakah laws. The deductible items have been examined in detail in the Shariah......These have to be taken account of and strictly adhered to, not only in the administration of zakah but in additional levies as well.

Third, double or multiple assessment of the same base is not possible in one stipulated period in zakah. Hence such a policy is to be avoided in case of other direct taxes.

Here three more Shariah-based prescriptions are added:(10)

First, once income/spending/wealth level crosses zakah nisab level, then the whole of income/spending/wealth should be taxed and not just that part which is in excess of nisab.

Second, tax tools should not be used to achieve, as far as possible, non-tax goals through a series of deductions, concessions and allowances.

Third, the rate bands of different taxes should greatly reflect the essence behind the rates of prominent Shariah levies where the thrust is on moderation.

The above prescriptions help and guide us when we contemplate an Islamic approach towards a self-enforcing tax system. It should strengthen the working of conventional Shariah levies, especially the zakah. It is their promotion and continuation that imparts a distinct Islamic character to the existing tax systems in Muslim countries.

(9) F. R. Faridi, “Zakah and Fiscal Policy” in Ahmed Khursheed (ed.) Selected Papers, Amar Prakashan, New Delhi, 1984, p.121. One can also refer to the classic works of great masters such as Abu Yusuf (1966), Abu Ubayd (1986), and al-Daudi (1995) In recent times the contributions of al-Qaradawi (1980) and Nejatullah Siddiqi (2001) are also significant. The Islamic Fiqh Academy, New Delhi, has also done commendable work in this area.
III

An alternative Islamic approach comprises a tax on gross income, an expenditure tax, the zakah, a withdrawal tax and an agency administering a scheme of “special deposit account”. On the periphery there would be corporation, gift, capital gains and property taxes. These constituents are briefly discussed in the following paragraphs.

Currently among all direct taxes, a tax on personal income occupies a pride place in all developed and developing countries including Muslim countries. It is viewed as an important means of revenue and an effective instrument of correcting unequal income and wealth distribution. In terms of percentage its contribution to the total tax revenue may not be high, yet it attracts maximum attention of the policy makers, tax administrators and taxpayers.

Currently, following the accretion ideal, income is computed on gross basis, however, tax is not imposed on gross income. First, a part of income is exempted. Next, a number of deductions, concessions, rebates, etc., are allowed. As a result, a significant portion of gross income gets excluded from the tax net. Consequently, to satisfy equal revenue condition, the tax rate is required to be higher than what it would have been when no such exemptions, deductions, concessions, rebates, etc., were allowed.

The present practice of allowing a number of deductions and concessions mainly for the non-tax purposes has diluted the pure income base (following the accretion ideal). It is now regarded as a hybrid base. A hybrid base is the one that conforms to neither the accretion ideal nor the consumption ideal. Further, this practice has also enabled a few assets to enjoy a relatively high index of fiscal privilege. This is an additional advantage that some persons enjoy by manipulating their tax affairs. Surely, the revenue outcome of a hybrid base would be entirely different from the one where the tax base remains undiluted following the accretion principle.

In this context it is argued here that when all deductions, concessions, exemptions, etc., are withdrawn so as to impose a tax on gross income, the above-mentioned weaknesses disappear. Even with a sufficiently low rate a substantially large amount of tax revenue gets collected. This requires bold policy decisions. Muslim countries should set a precedent and should not wait for the one from Western countries. Following the Shariah principles the entire income of a taxpayer should be taxed if it exceeds the minimum exemption level.

An expenditure tax is another important constituent of the Islamic approach. Following the consumption ideal, here the tax base is personal consumption expenditure. It is not for the purpose of promotion of savings alone that an expenditure tax is favoured but more importantly for the reason that no other tax but an expenditure tax prevents depletion of scarce resources by charging dissaving. “Taxes on consumption expenditure may some time become necessary to discourage deliberate evasion of zakah and willful obstruction in the fulfillment of its secondary function namely the promotion of productive investment of one’s savings”.

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(11) The working of personal income taxation in India, Pakistan and several other countries lend support to this contention.

There are reasons to believe that an expenditure tax helps Muslim countries to achieve broad goals of Islamic fiscal management, more conveniently than any other direct tax\(^{13}\). In brief these reasons are, first, an expenditure tax helps to curb ostentatious consumption. Second, since savings are tax free, it releases more finance for economic growth. Third, it helps to control inflation and thereby maintain price stability. Fourth, it facilitates expansion of the existing zakah base. Of the four mentioned above, it is emphasized here that the first three are incidental to the introduction of an expenditure tax and the primary and motivated reason happens to be the expansion of zakah base.

Savings assume different forms such as bank deposits, shares, investments in real estates, participatory loans and investments in numerous other financial and non-financial instruments. This undoubtedly expands zakah base because zakah primarily covers different types of productive assets. No other direct tax but an expenditure tax helps in promoting and strengthening zakah base, to the advantage of both the Muslim ummah and Muslim countries. With passage of time more attractive forms of savings and investments have appeared and their number continues to multiply. The Islamic approach maintains that the financial and non-financial assets that are above nisab, complete one year and are free from debt, come under the reach of zakah.

For tax purposes it is directly not possible to keep a record of consumption expenditure spread over the purchases of numerous goods and services. It is exactly for this reason that the computation of expenditure for tax purposes is approached indirectly following the basic relation between consumption and savings components of income, i.e., \(c = y - s\). Once savings are tracked the computation of chargeable consumption does not pose any problem.

Under an expenditure tax regime, in order to claim a cent percent deduction, it is required that all savings and investments are recorded. Unrecorded transactions are treated on “cash flow” basis and are taxed. Since a cent percent allowable deduction is tagged to the recorded savings and investments, the expenditure taxpayers get a strong incentive to record the same and, therefore, zakah base expands to the extent of their recordings. This incentive could be further enthused when the amount paid in zakah also qualifies for a cent percent deduction from gross income or expenditure.

In this alternative Islamic approach a special place is occupied by zakah. Ordinarily the zakah does not belong to the broad genre of taxes imposed by a state. So also the funds collected through zakah do not belong to the ordinary genus of revenue. But, purely from the economic view point, the zakah is an impost, which like any other levy, effects a transfer of resources from private to the public use for an earmarked spending. Even though the revenue from zakah can not be spent on the heads other than those enumerated in the Holy Quran [9:60] it can be said that the extent to which zakah funds are available to the state for spending on poor, destitute, needy and indigent, the broad purpose of any resource mobilization effort, i.e., poverty alleviation, is served.

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There are at least three reasons to believe that the levy of zakah is likely to provide substantial funds to the state exchequer\(^{14}\). First, it makes accessible to the tax authorities such items as ordinarily beyond their purview. Second, the low exemption limit of zakah enables the state to throw its fiscal net quite wide. Third, the incentive effect of zakah is likely to increase productive investment and hence net savings in the economy. As this happens, the zakah base widens and brings in more resources.

At this juncture one objection can be anticipated. A system, where the zakah and an expenditure tax operate side by side, is on a self-destruct path for the reason that the levy of zakah would cancel incentives to save. Therefore, one should not expect promotion of savings, investment, capital formation and thereby high growth rates. This criticism, however, is not well founded. The imposition of zakah leads to a persuasive utilization of assets that in the absence of zakah would have remained idle. This effect of zakah can be understood in the context of a circular relationship between zakah and increased investment on one hand and zakah and increased transfer payments on the other. One set of forces strengthens supply-side and the other stimulates demand. Further, what the zakahpayers are going to do with their large savings when it is feared that the zakah on an annual basis depletes their savings? Will they notice silently a gradual decline in their accumulated balances? How they react to this adverse situation that gets worsened further on account of a persistent fall in the value of money on account of inflation?

Indeed, it can be said that, the fear of a gradual depletion in savings alongside a fall in the value of money force zakahpayers to find out suitable avenues of investment. Supposing that they are not wise enough to understand intricacies of financial markets so as to invest personally, they can undertake investment through secondary sources, i.e., financial institutions, investment houses, mutual funds, etc. Even deposits in commercial banks can be considered as a safe investment. Therefore, it is maintained here that the investments increase following an increase in savings.

It should not be ignored that the assets on which zakah is paid are subject to a “divine multiplier” [The Holy Quran 2:261-62]\(^{15}\). As against conventional economic wisdom (substitution effect) it is not difficult to find Muslims who earn more (economic effect) to save more so as to pay more zakah in order to earn ethereal reward (merit effect)\(^{16}\). In this context zakah is not considered as a levy but a celestially ambrosial incentive to save. As zakah is considered as a means of seeking the pleasure of Almighty Allah, it is not expected to reduce savings, it, on the contrary, increases the same.

The Islamic approach towards a self-enforcing tax system requires, for the sake of administrative simplicity and convenience, setting up of a National Equity Fund (NEF), which administers a scheme of Special Deposit Account (SDA). The contributions to SDA qualify for a cent percent deduction. It is merely a matter of policy before governments in the Muslim countries to declare which saving-schemes they are going to

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\(^{15}\) One must not cast doubt on introducing the concept of “divine multiplier” here in our discussion. The divine reward is guaranteed by the Almighty and, therefore, a Muslim is required to accept it in letter and spirit.

treat as fully tax deductible. The NEF would undertake investment on behalf of its contributors who have no or a very limited knowledge to understand complexities of financial markets\(^{(17)}\).

It is also suggested the proposed NEF should be authorized to deduct zakah at source on the savings of each one of the contributor, provided it is above nisab and that it has completed one year under the administration of NEF. Further, the NEF adhering to the expenditure tax principle collects a tax on withdrawals that are permitted after a stipulated period. This covers consumption financed out of dissaving. A progressive income tax with adequate saving provisions does not restrain a taxpayer from dissaving. Thus, in Muslim countries the NEF is expected to perform the following functions:

First, it mobilizes funds and channels the same into productive business and commercial ventures on behalf of its numerous contributors and share profit and loss with them.

Second, it deducts zakah annually from the capital of each one of its contributors, provided Shariah conditions are satisfied.

Third, it deducts a tax on withdrawal at source in the year of withdrawal.

Let us consider the following numerical example of a hypothetical taxpayer who earns one million rupees per year. As his income exceeds the nisab level, he is, therefore, taxed on his gross income. Further, he contributes Rs.200,000/- to the NEF. Since we are following consumption criterion as well, contributions to the NEF are fully tax exempt. The remaining amount of Rs.800,000/- is taxed on cash flow basis. There at the NEF level, after the completion of one year, Rs.200,000/- are covered for zakah purposes. The dividend remains untouched. It may be remitted or reinvested by the NEF on the instructions from the contributor. Suppose that the contributor, after the completion of stipulated period, decides to withdraw his contribution with the NEF. The NEF now imposes a withdrawal tax. Thus, at every stage of earning (the accretion principle) and spending (the consumption principle) our hypothetical taxpayer is required to pay something to the state exchequer. He pays zakah as well on his contributions to the NEF.

There could be a large number of people who prefer to save and invest independently of the NEF in one or more profitable business ventures. Here it is proposed that such investors should pay zakah directly to the zakah authorities and thereby claim deduction for the amount paid in zakah from their total taxable income. The monitoring of zakah base (and consequently consumption base) is possible because in the year preceding zakah payment they had asked for a cent percent deduction of the amount paid in zakah. Here tracking of the sale of assets accumulated tax-free is also possible because in the next year zakah will not be paid on them. Consequently, these are included in the gross income in the year of sale and taxed accordingly. It is no longer necessary to impose a wealth tax because its purpose is well served by zakah. However, a wealth tax or a property tax could be imposed on such of the assets that are not normally covered under the purview of zakah.

\(^{(17)}\) It is not necessary that there should be only one institution of the type of NEF as suggested, there could be many. In several countries such organizations are functioning at the government and private levels as well. The essence of this proposal is that there should be some record of contributions, i.e., savings and investments, so that these qualify for a cent percent tax deduction.
IV

It is clear from the above discussion that it is possible to present an alternative Islamic approach of a self-enforcing tax system. On one front of the self-enforcing tax system, zakah occupies a pre-eminent position, on the other front a gross tax on income, an expenditure tax and a withdrawal tax operate to support one another so as to reinforce the system. The creation of NEF facilitates flow of funds into productive channels. This approach makes taxpayers to pay at each and every stage of accretion, consumption and accumulation. It makes attempts of evading taxes less attractive than before for two reasons. First, from the gross income a cent percent deduction of the amount paid in zakah is claimed. Second, a cent percent deduction is claimed on contributions to the NEF. There is a sufficient provision for cross-checking too. Once contributions to the NEF are reported, consumption is tracked and vice versa.

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الخلاصة: هذه الورقة محاولة لتطوير نظام ضريبي إسلامي عن النظام الضريبي السائد لإيجاد نظام ضريبي ذاتي مباشر. هناك عدد كبير من الدول الإسلامية التي هي حاليا منفصلة اقتصاديا ومما هذا تأهيل جهود تعبئة الموارد المالية مكان التجارة. فرض الضرائب هو واحد من أهم أساليب تعبئة هذه الموارد.

يسع النظام الجديد الضرائب المفروض ذاتيا، حيث لا يستطيع فقط على جميع الموارد المالية ولكن يقلل أيضا من نسب الموارد نتيجة التهرب من الضرائب، ويمكن تعريفه بأنها النظام الذي إذا ما حاول دفع الضرائب في التهرب من ضريبة ما وجد نفسه تلقائيا أمام ضرائب أخرى مما يجعله محاولة تبوء بالفعل، فهذا النظام ينجم إذن الشخص الأيمن على دفع الضرائب.

لا يمكن لأي نظام ضريبي ذاتي أن يسمى إسلاميا إلا إذا حقق في شرطان الأول، لا يد ان تكون الزكاة هي صلب جهود تعبئة الموارد، والثاني يجب أن يكون علي حد أدنى من قوانين الشرعية بالإضافة إلى القوانين المنظمة التي تحدد مباعلاه ونصبه وإدارته. فمن جهة تعتلى الزكاة موقف الصدارة في هذا النظام الإسلامي المفروض في هذه الورقة، ومن جهة أخرى فإن الضرائب على الداخل والضرائب على الاستهلاك والضرائب على السحب يساهم بعضها بعض البعض للفوائد هنا النظام. هذا النظام يجعل دفع الضرائب في كل مرحلة من مراحل زيادة الداخل والاستهلاك والموارد.