

## Place for an Expenditure Tax in the Islamic Fiscal System

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ABSTRACT. An attempt is made to develop a case in favour of introduction of an expenditure tax in Muslim countries. The income tax is a good source of revenue but its administration is beset with innumerable problems. Presently more and more doubts are raised over the appropriateness of personal income tax. The consumption based personal expenditure tax is considered as an efficient substitute to the income tax. The paper argues that given the requirements of Muslim countries a direct tax on personal consumption expenditure would be more suitable among all other direct taxes. It would eminently fit into their systems so as to strengthen the working of zakat and other direct taxes. Its introduction would help in financing a high level of economic development. Since it is highly anti-inflationary, its introduction would help in controlling inflation and achieving much desired price stability. More importantly, an expenditure tax by favouring saving vis-à-vis consumption would expand zakat base. In order to realise these advantages an attempt is made in this paper to develop a workable model of an expenditure tax which would incorporate within itself the *shariah* based prescriptions. Profit and loss sharing, categorization of saving schemes and creation of national equity fund are some of its prominent features.

### Introduction

This paper develops a case in favour of taxation based on consumption principle vis-à-vis accretion principle so that an expenditure tax can be introduced in Muslim countries. An expenditure tax would support critical minimum resource mobilisation in Muslim countries by expanding and strengthening the zakat base, besides numerous other advantages.

## 1. Critical Minimum Resource Mobilisation in Muslim Countries

A certain critical minimum resource mobilization is mandatory on the part of a Muslim state. This is for the reason that the Islamic *shariah* is very particular about the welfare of vulnerable sections of society. The core of critical minimum resource mobilisation effort is zakat, which is an inviolable part of the Islamic belief. It is held as a “microcosm of the entire Islamic economic system; that it embodies the entire Islamic philosophy; that it is the irreducible minimum ingredient of the Islamic fiscal system; and that it is the fulcrum of the Islamic economy.... Zakat has to play a crucial and extended role in affecting, shaping and directing the Islamic economy, virtually in all of its important ramifications; it has to eradicate poverty, ensure equitable distribution of wealth to the desired level, stimulate economic growth, act as a counter cyclical economic stabilisation device and promote social welfare....”<sup>1</sup>. Islam institutionalised zakat to ensure that no one suffers for want of resources to meet 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 socialism and the secular welfare state have unwittingly done”<sup>2</sup>.

Zakat is a general term which is applied to all compulsory impositions levied and collected by a Muslim state on the productive assets of its eligible Muslim residents, i.e., *sahibu'n-nisab*<sup>3</sup>. It is a broad-based levy and an important source of revenue in the sense that a steady flow of funds is assured throughout the year<sup>4</sup>. At the same time it is not a source of revenue as understood in ordinary sense of the term as the end-use of funds is clearly predetermined and earmarked. In this context it can be pointed out that the Quran has identified eight heads of which poor and needy top the list. They occupy a central position in the Islamic public expenditure policy.

## 2. Place for Additional Levies

Islamic scholars have given adequate attention to a study of the issue whether an Islamic state can introduce taxes other than zakat and those which were operative during the period of the Prophet and the righteous caliphs. In this matter Islamic scholars in the past exercised much restraint and advised rulers that the introduction of additional levies should be an exception. They were right for at least three reasons. First, flow of funds to the state exchequer by the way of conventional levies was quite substantial. Secondly, the area of economic activities and the extent of state intervention were quite limited. Even though the early Islamic state did perform the role of a welfare state, many of its functions were rudimentary in form and nature. Finally, since at that time the world was passing through the first stage of demographic transition, the early Islamic state had to serve a very small population. On account of these three reasons the need for resource mobilisation through non-conventional and non-*shariah* levies on a regular basis was not that great.

Given the emerging fiscal scenario in a large number of Muslim countries, the right of an Islamic state to raise additional revenue cannot be challenged. The use of modern techniques of raising revenue in subserving the broad objectives of Islamic fiscal policy would not be incompatible with the *shariah* framework provided resources are raised in a “just manner”. The case for additional secular levies is based on this Quranic verse: “They ask thee how much they are to spend; Say: what is beyond

your needs”<sup>5</sup>. There is also a tradition of the Prophet: “In the wealth (of a Muslim) there is due (a share) over and above zakat”<sup>6</sup>. Abu Ubaid quotes Ali: “Allah has made obligatory upon the rich to pay out of their wealth whatever is sufficient for the poor. If the poor starve and go unclad or suffer difficulties it is because the rich have deprived them. Hence it is proper for God, the Almighty and the Exalted, to bring them to account and punish them”<sup>7</sup>.

The issue of secular taxes should be studied in the context of introduction of *kharaj* and trade taxes as an innovative exercise in taxation. Further, during the period of righteous caliphs it happened that sometimes the number of zakatable items was increased and at others it was decreased. Thus, a clear message underlying the practice is that achieving the *maqasid ul shariah* should be of paramount importance and resources should be mobilised so as to achieve the *maqasid*.

Imam Malik, Imam Shatibi, Abu Yusuf, Imam Ghazali, al Kasani, al Marghinani, Ibn Hazm and al Rabi are a few among many Muslim scholars who are very often quoted in support of the introduction of new taxes<sup>8</sup>. Qardawi<sup>9</sup>, Hamidullah<sup>10</sup>, Siddiqi<sup>11</sup>, Faridi<sup>12</sup>, Chapra<sup>13</sup>, and Hasanuz Zaman<sup>14</sup> are a few prominent scholars of our times who support the right of an Islamic state to levy secular levies. In particular a mention could be made here of Siddiqi who visualises the use of additional levies to achieve certain goals of fiscal management such as curbing ostentatious expenditure, economy in the use of scarce and non-renewable sources of energy and for financing provision of such of the services which cannot be bought in the open market. He is of the view that the only guiding principle should be that the secular levies should not be too harsh and unbearable<sup>15</sup>.

### 3. Income and Expenditure Tax Bases Described

Here it is necessary that one should have a fair idea of what income and expenditure tax bases are? Haig-Simons prescription defines income in terms of the uses to which the tax unit<sup>16</sup> put its resources during the year<sup>17</sup>. Following this income would be the familiar accounting identity:

$$(1) \quad Y = C + \Delta W$$

where Y, C and  $\Delta W$  stand for income, consumption and change in networth (“savings”) over the accounting period respectively. To employ income as a tax base requires putting operational flesh on the concepts of consumption and savings. It should be emphasised that the terms “consumption” and “wealth” are not operationally defined a priori; they are defined in the process of determining tax policy. Practical calculation of either income or consumption tax base normally starts with the individual’s receipts rather than his outlays<sup>18</sup>. Let  $W_i$  stand for the wealth at the beginning of period i, and  $E_i$  for the “nonwealth receipts” (wages, transfers and so forth), understood as occurring at the end of period i, at the same time as returns on wealth,  $rW_i$  and consumption  $C_i$ . For these concepts to form a satisfactory accounting system it is necessary that

$$(2) \quad W_{i+1} = E_i + (1+r)W_i - C_i$$

or

$$(3) \quad C_i + \Delta W_i = E_i + rW_i$$

The left-hand side of 3 is Haig-Simons income; the right-hand side, the sum of nonwealth receipts and return on wealth accumulated upto date  $i$ , is the usual calculation base. The same approach is normally taken to calculate a consumption tax base; savings are subtracted from the sum of nonwealth receipts and return on wealth:

$$(4) \quad C_i = E_i + rW_i - \Delta W_i$$

The difference between an income base and a consumption base lies entirely in the treatment of savings. The consumption based expenditure tax excludes savings. In other words all contributions to common wealth are excluded for tax purposes while all withdrawals from common wealth are included in the tax base<sup>19</sup>. One should not be, however, under the impression that in practice every piece of expenditure is taxed. In reality a good part of total expenditure, mainly the subsistence expenditure, would go tax free. This is in conformity with the statistically confirmed Engle's law that socially and economically weaker sections of the society when compared to affluent spend a higher portion of their incomes on procuring essential requirements of life. The rich are capable of retaining quite a substantial portion of income over and above the basic expenditure. It is to tap this surplus that the need for different taxes is felt.

It is needless to say that under an expenditure tax regime subsistence expenditure goes untaxed. This is same as under an income tax where subsistence income goes untaxed. From this it can be derived that at the subsistence level both income and expenditure are held to be equal to each other. Since subsistence expenditure remains exempted, it would be wrong to claim that an expenditure tax would be regressive putting a heavy tax burden on the poor who are supposed to have a high level of marginal propensity to consume<sup>20</sup>. It is a common practice in almost all countries where an income tax is administered that there is a regular revision of subsistence level expenditure. In poor countries, many of which are Muslim countries, it would be better to exempt a fairly high level of expenditure treating it as subsistence expenditure. The same should be regularly revised to inject certain amount of fairness into the tax system.

It is generally alleged that inflation would lead to a higher personal spending than before and thereby it would invite heavy tax on expenditure. In other words for no fault of their's, taxpayers would be required to pay a tax on nominal increase in their personal expenditure. Hence, an expenditure tax would be putting more burden on taxpayers at times when their real incomes fall on account of inflation. There are two types of inflation adjustments. One is related to rate structure and the other to tax base. The former requires inflation indexation of exemption level, standard deductions and adjustment in tax brackets. These adjustments are less complicated. The latter requires adjustment for price variation over various periods in computing capital gains, depreciation, inventory costs, changes in the value of outstanding debts and adjustment for inflation premium in interest rates. These adjustments are extremely complicated and are indispensable under an income tax regime. The burden of the nominal increase in expenditure could be minimised by suitable changes in exemption limits. Very often governments raise these limits to compensate for price rise otherwise they would have to face public resentment<sup>21</sup>.

#### 4. Major Economic Issues Affecting Choice between Income and Consumption

The present system of direct taxation is primarily income-based; be it personal income, corporate income, business income, income from property, transfer income agricultural income, et. al. Income is generally regarded as a convenient index of ability to pay. In a number of countries personal income tax occupies a pride position. There is no doubt that the income tax is a convenient and dependable source of revenue, but its administration is beset with innumerable problems.

Presently more and more doubts are raised over the appropriateness of a personal income tax. It has become too complicated; inflation distorts intended effects of the system particularly with respect to income from capital; the mass of special features in the code diverts resources from productive activities towards tax gamesmanship: the system provides substantial benefits to those who can manage to take advantage of loopholes and the system administers a progressive rate structure which chokes work, saving, investment and productive enterprise. "A number of studies related to the United States has shown that, while the rate structure maintained a facade of progressivity, the numerous exclusions, exemptions, deductions and credits reduced it effectively... Every item removed from the tax reduces revenue and probably makes the income tax less fair... Even in the case of Sweden, apparently an ideal welfare state, the position is that the income tax may be steeply progressive on paper, but the rich have learned to use a complex system of deductions to lighten their tax burden... people can stay rich by exploiting asymmetries in the tax system. Thus, there seem to be a wide spread recognition now that progressive taxation has not only not played a significant redistributive role anywhere, but has rather also possibly operated in the reverse direction in some countries"<sup>22</sup>.

Therefore, in this context and with a particular reference to the personal income tax, the following questions are asked again and again: Is income a proper index of ability to pay? Is it for the purpose of taxation possible to offer a universal definition of income? Are all components of income included in the tax base before computing tax liability? Should not a refuge be taken in the alternative index of ability to pay, say consumption?

A widespread dissatisfaction with the accretion type income tax will not require us to count the number of arguments favouring an expenditure tax<sup>23</sup>. The case for an expenditure tax is clearly strong when the following propositions are established:

1. Income is a defective index of ability to pay. It needs to be supported by other taxes such as wealth tax, inheritance levy, gift tax, etc.
2. There are many difficulties in defining and measuring income and these get accentuated with inflation.
3. A defective definition of income is a mismeasurement of ability to pay.

In this context only two major issues are examined.

#### 4.1 Tax treatment of savings

Traditionally the case for an expenditure tax is associated with the issue of “double taxation of savings”. Debate over this issue is one of the classics in economic literature which was initiated by Mill. He terms income tax as unjust and impolitic because it leads to a double taxation of savings. “To tax the sum invested and afterwards tax also the proceeds of the investment, is to tax the same portion of a contributor’s income twice over”<sup>24</sup>. Mill, thus, declares that no income is really just from which savings are not exempt and no tax law ought to be voted without that provision.

Pigou supports Mill maintaining that a general income tax as understood in England can be shown to discriminate against investment: “An income tax discriminates against savings first by hitting at the principal and then hitting at the yield. And if the amount saved is never withdrawn, then every year yield is taxed regularly, in other words the effective tax rate on saved income is practically double the rate of tax on expended income”<sup>25</sup>.

Fisher provides a mathematical proof of double taxation of savings maintaining that the argument is probably the most basic as well as most neglected. “For this argument we need not depend upon authority. There is a mathematical proof... the proof that if savings are taxed as income and again income of these is also taxed, there will be a subtle form of double taxation”<sup>26</sup>. Fisher points out that any tax on saving is merely a pretax on their yield. “If we were to tax yield *after* it comes we should not also tax it *before* it comes unless of course we really want it for some special reason to tax the same thing twice”<sup>27</sup>. It is true that if income tax discriminates against savings, an expenditure tax discriminates against spending. But if the comparison is to be meaningful there should be a third common measure and that is capitalisation. It is based on the ground that a tree derives its value from fruits.

Recent studies such as Blueprints for Basic Tax Reform and Lodin Commission Report have also supported the contention of Mill, Pigou and Fisher. Blueprints points out that “a serious drawback of an accretion base is that it leads to what is sometimes called as double taxation of savings”<sup>28</sup>. The Lodin Commission Report observes:” In income taxation bank savings and other similar forms of saving with a high direct yield are subject to full double taxation. First the income is taxed when it is saved. Subsequently the yield on it is taxed as and when it becomes available for withdrawal. As a result there is an annual draining of the yield for purpose of making tax payments. This limits possibilities of growth”<sup>29</sup>. Kust<sup>30</sup>, Aaron and Galper<sup>31</sup> and many others have lent their support to this contention.

The argument that there is no double taxation of savings also runs parallel. Musgrave<sup>32</sup>, Kahn<sup>33</sup>, Goode<sup>34</sup> and many others maintain that the term “double taxation of savings” is pejorative and should be deleted from the vocabulary of tax debate. Chelliah observes that an income tax does not tax savings but income from savings<sup>35</sup>.

If for a moment the issue of double taxation is kept aside, then what matters most is not the number of times a tax is imposed but the ultimate tax burden. The accretion type income tax places a heavy burden on savings. In case of an expenditure tax while

the present consumption is postponed and payment of tax is delayed, savings so accumulated are available to the authorities for financing economic development. These are also available to individuals along with their yield, for spending in future. This does not happen in case of income tax. Not only savings are discriminated but the future tax base is narrowed to the extent of present tax liability. In the long run double taxation would not yield more revenue to the exchequer but on the contrary it would reduce the same<sup>36</sup>.

Income tax may be said to discriminate against savings in another way. If a certain portion of income is spent on consumer durables, such as a painting or a work of art, the income in-kind flowing from the use of assets is not taxed whereas if the same portion of income is invested in business assets, money income derived therefrom is taxable.

#### 4.2 Return to saving

The point that an expenditure tax allows a favourable return to saving is illustrated with an example<sup>37</sup>. Suppose that an individual receives \$1000 which he intends to save for one year and then spend together with the interest earned. Suppose also that the current rate of interest is 10 percent and the individual can be subject to either an income tax or an expenditure tax. The differential effects of the two taxes are shown in the following table. With the 50 percent income tax, \$500 is extracted in tax, leaving \$500 to be saved. The interest earned after one year amounts to \$50 but half of this is taxed as well, leaving a total of \$525 as disposable income<sup>38</sup>.

**Table : Income Tax, Expenditure Tax and Savings**

|                         | Income Tax   |     |                  | Expenditure Tax |     |                  |
|-------------------------|--------------|-----|------------------|-----------------|-----|------------------|
|                         | Gross amount | Tax | Net amount saved | Gross amount    | Tax | Net amount saved |
| Money Received          | 1000         | 500 | 500              | 1000            | 0   | 1000             |
| Interest after one year | 50           | 25  | 25               | 100             | 0   | 100              |
| Money spent             | 525          | 0   | 525              | 1100            | 550 | 550              |

Under an expenditure tax regime there is no liability when money is received. This means that the entire \$1000 can be saved and that a higher amount (\$100) is received in interest after a year. As the interest is not taxed when it is paid out, this makes a total amount of \$1100. When this is spent, the 50 percent expenditure tax on the gross figure accounts for \$550, leaving another \$550. Thus, a taxpayer feels better off, from the view point of both earning more interest and spending more, under an expenditure tax regime.

It is also clear from the above table that an expenditure tax results in a higher return to saving than an income tax. If the higher return encourages a higher level of savings, then an expenditure tax is likely to be more favourable to savings than an income tax imposed at the same rate. Another advantage of this favourable treatment to savings would be that an increase in private savings itself would release resources which could be used to support a high level of development expenditure.

## 5. Other Related Observations

In many countries there are provisions in the income tax laws to promote savings or to put in other words, to minimise the bias of income tax against savings. This is a welcome feature. Basically these provisions pertain to full or part exemption of saving/investment in government approved forms. But these are subject to monetary limits. These limits could be attributed to, and become necessary for, the reason that a full deduction will nullify the definition of income. When there are no upper limits, it amounts to a conversion of tax base from income to consumption.

Another observation is that under the income tax regime in order to promote savings, fiscal authorities allow both the amount invested in approved securities and yield thereon to be treated favourably. This rule does not satisfy either the accretion ideal or consumption ideal. In fact it amounts to shooting tax base beyond consumption.

Under any savings promoting scheme it is desirable that the investments which are being encouraged should have broadly similar rates of return. Variations in the rates of return should be only on account of difference in holding period, risk or some overriding consideration. However, one finds arbitrary variations in the rates of return due to a differential tax treatment. This creates distortion in the allocation of savings. Apparently these are not meant for any genuine promotion of savings but more for diversion of funds from private to public sector. As a result "the index of fiscal privilege of a few assets goes up"<sup>39</sup>.

Taken on the whole while savings are not genuinely promoted there appears to be no provision in the current tax laws to penalize dissaving, which according to Kaldor is more important than promotion of savings. In his opinion the case for an expenditure tax should not be exclusively associated with the promotion of savings alone but a charge on dissaving. "It is the charge on dissaving, much more than the exemption of savings, that distinguishes an expenditure tax from an income tax"<sup>40</sup>.

## 6. Administrative Feasibility

It is a truth universally acknowledged that individuals do not keep records of their personal expenditure. It is really impossible to chase them in their spending sprees. On this particular ground it is very often alleged that whatever the theoretical superiority of an expenditure tax, difficulties in its administration are many. When chargeable expenditure is not computable its administration would be then a distant reality. It is, therefore, necessary to establish a proposition that it is possible to have a simple technique for computing this particular tax base. The question of advantages of an expenditure tax would hardly be of any practical interest if the search for such a technique proves futile.

The proponents of an expenditure tax argue that there are three major ill-founded propositions which have contributed to the notion that in practice it is difficult to administer an expenditure tax. These are:

- 1) It is impossible to compute personal expenditure.
- 2) Exclusion of savings narrows tax base.
- 3) Cash flow treatment of different assets is difficult.

Now its proponents have produced sufficient literature to demonstrate that the personal expenditure is easily computable. Its efficient administration is more certain than that of an income tax of most comprehensive type. Even though savings would be excluded, its base would not be narrow as feared. Further, a computation based on cash flow is the most objective reflection of spending power exercised<sup>41</sup>.

The first systematic effort in the direction of computing chargeable expenditure was made by Irving Fisher. He proved that for tax purposes personal expenditure could be easily computed if an indirect method is adopted. Fisher was fully aware of the fact that while Mr (money receipts) are recorded with accuracy, Ms (money spent) is not recorded with the same degree of accuracy. He envisioned an idea of reaching Ms indirectly when a taxpayer is asked to report how much amount he had in the beginning of the year and how much he is left with. On this basis it would be easy to arrive at his total spending. To put operational flesh for tax purposes, non-personal expenditure is subtracted from total spending. Fisher's idea is unique in the sense that for the first time computation of chargeable expenditure was demonstrated. He proved that an indirect method is equally useful, reliable and has the same degree of accuracy as present direct method.

In recent years the notion of cash flow accounting has received wide attention where outflow of cash represents in money terms the total expenditure from which expenditure on non-personal uses is subtracted and remaining is taxed on cash flow basis. Cash flow accounting is now the central feature of any model tax system wherein an expenditure tax occupies a place. In fact the advent of cash flow accounting has falsified the proposition that an expenditure tax is infeasible.

From the view point of administration there are several advantages in choosing expenditure as a tax base. Several difficulties arising in the enforcement of a comprehensive income tax would be removed. Problems involved in the measurement of depreciation, inflation adjustment, estimation of gains, allocation of income, etc., would not be necessary. There is, therefore, no need to measure them, no need to estimate depreciation, accruing capital gains or accruing rights in pension plans or life insurance policies. If no transactions take place then there is no need to be concerned about these forms of income and wealth.

Further, the currently administered income base already contains important elements of consumption base by allowing some forms of savings and investments partially deductible for tax purposes. Even interest income is only partially included in the tax base. Since income base has already shifted in the direction of consumption, and in some cases even beyond consumption, the administration and introduction of an expenditure tax on a cash-flow basis would not be radically different to cause severe administrative problems. It, therefore, follows that administrative and compliance costs would not be substantially high to warrant an outright rejection of expenditure tax idea. On the contrary, with the introduction of an expenditure tax it would be possible to have a more effective system of cross-checking. This cross-checking would further improve administrative mechanism of wealth tax and even zakat.

An important consideration in assessing the administrative feasibility is the extent to which the tax is to be applied. If the tax is in addition to the income tax, the considerations are different than if it is in replacement of the income tax. Many ardent supporters, including Kaldor, are of the view that first a cautious beginning should be made and in the initial stage an expenditure tax should supplement income tax. A sudden and complete shift in favour of an expenditure tax would create several problems. On the contrary the advantage of supplementing income / wealth tax with an expenditure tax would be that the information as supplied in an expenditure tax return would be helpful in improving overall system by enforcing an effective system of cross checking. But, it is rightly pointed out that “as in case of most taxes, administrative feasibility is, in the end, a function of the extent to which perfect equity and economic and social objective can be compromised for the sake of administrative simplicity”<sup>42</sup>.

### **7. Why Not an Expenditure Tax in Muslim Countries**

An important issue involved in the discussion on the place of secular taxes in Muslim countries is that which direct tax is more suitable and why? Given the requirements of Muslim countries it can be argued that a direct tax on personal consumption expenditure would be more suitable among all other direct taxes. Because of certain in-built advantages, it has a place not only in non-Islamic but in Muslim countries too. It eminently fits into their tax systems so as to strengthen the working of zakat and other direct taxes.

There are reasons to believe that an expenditure tax would help Muslim countries to achieve the broad objectives of Islamic fiscal policy more conveniently than any other direct tax, particularly the critical minimum resource mobilisation through zakat. These reasons are: First, introduction of an expenditure tax would help curb ostentatious consumption. Second, it would help finance a high level of economic development. Third, it would help control inflation and maintain price stability. Fourth, it would help expand the existing zakat base.

### **8. Curbing Ostentatious Expenditure**

The Quran and teachings of the Prophet are averse to ostentatious, pompous and conspicuous expenditure. The Prophet of Allah is reported to have said that the Almighty does not approve (1) unnecessary discussion (2) waste (of resources and time), and (3) begging<sup>43</sup>. It could be pointed out here that of the three the latter two are closely interrelated. It is possible that a wasteful and unwise use of productive resources, which are normally short in supply, might take individuals, and nations as well, to the point of economic ruin and disaster. This particular tradition of the Prophet can be further supported by numerous instances drawn from the pages of history, that a rapid downfall of mighty empires was caused by reckless spending by both the rulers and the ruled. Ibn Khuldun observes in his *al Muqaddimah* that there are five phases in the lifespan of an empire<sup>44</sup>. The fifth and final phase is characterised by a phenomenal increase in wasteful luxurious consumption and spending by men of affairs, leading to a rapid erosion of political authority and decadence of moral culture. Shah Waliullah’s observations on the decline of mighty Mughal empire in India corroborate the view of Ibn Khuldun<sup>45</sup>.

The wasteful consumption expenditure might assume four different forms: excess expenditure on personal requirements; expenditure on inconsequential and frivolous matters; supercilious expenditure and expenditure without regard to requirements of time and society. Since all these forms of expenditure go against the teachings of the Quran and Sunnah and also hurt economic, social and political interests of the state and community, an Islamic state has every right to curb them in one way or the other. For instance, the state could make it obligatory for rich people to obtain its permission prior to spending or when economic and political stability is at stake the state may totally prohibit certain forms of spending<sup>46</sup>. Here a direct tax on personal consumption expenditure would be of immense use because it plays a dual role of (1) curbing wasteful expenditure and (2) releasing scarce resources for more productive uses. A severe denouncement of luxurious lifestyles and ostentatious spending implicitly means that Islam commands flow of funds into productive channels. It is not, therefore, wrong here to argue that the Islamic fiscal system requires a tool which falls heavily on conspicuous consumption. An expenditure tax, thus, arguably fits into the Islamic fiscal system.

In Muslim countries there is great need for reducing *israf* (prodigality) in consumption. This is considered necessary for strengthening and promoting zakat base. It is observed that in a Muslim country "... if the government wants to implement zakat system by legislation it should simultaneously launch an educational and moral suasion programme to reduce *israf* in consumption. Reforms in important policies and tax structures can help in achieving this objective. In short, the starting point for any government should be one... to impose zakat at the rate of 2.5 percent along with policies to reduce *israf* in consumption both in public and private sectors"<sup>47</sup>.

It could be alleged that since one of the prime functions of fiscal management is to curb lavish spending, the same can be achieved by using specific levies on different types of goods and services. Further, commodity taxes have been around much longer, have provided much experience in tax administration than personal income tax. The balance, therefore, tilts in favour of using commodity taxes vis-à-vis less tried direct tax expenditure, at least on the ground of administrative simplicity.

Although the above mentioned reservation against an expenditure tax is a serious one, it should be noted that commodity-based taxes are regressive and very often cause cost-price escalations. Further, the concept of luxurious goods is dynamic. It would be rather difficult to regard a particular commodity or group of commodities as items of luxury because it might happen that after some time these may not retain that character. Above all, when the aim of fiscal management is to curb overall spending and to release scarce resources into productive channels, a direct tax on consumption expenditure would definitely have a clear edge over commodity taxes, leaving consumers free to choose commodities of their choice. It serves the purpose of rationing of spending power.

Another challenge to the notion of an expenditure tax comes from the income tax proper, that a progressive income tax would itself limit the purchasing capacity of individuals with higher incomes. When excess of income is siphoned off by using a progressive rate structure, the question of curbing luxurious expenditure does not arise

because taxpayers are left with less money than before. But, the point very often ignored here is that there are limits to progressivity. When income tax rates are very high, there are greater possibilities of tax evasion. At the same time howsoever progressive an income tax might be, it fails in curbing spending financed out of dissaving. Also it does not provide an incentive to save. An expenditure tax would, on the one hand, charge consumption financed out of both current income and dissaving, on the other it would provide a strong incentive to save more in order to minimise tax burden. In fact a more important test of an expenditure tax lies in charging dissaving, which a combination of income and commodity based taxes simply fails to achieve.

## 9. Financing Economic Development

A large number of Muslim countries are either “least developed” or “developing”. This is also true in case of capital surplus oil rich countries. Since the rate of economic growth is low, these countries are no match, politically, militarily and economically, to the developed countries of East and West. Therefore, attaining a high rate of economic growth should receive highest priority in these countries. A satisfactory growth rate would take care of many of social, economic and political ills.

There is a conventional argument in development economics that with limited possibilities of increasing the supply of land and a given rate of population growth, major sources contributing to economic growth are accumulation of capital and improvement in the efficiency with which resources are used, i.e., technological progress. Of the two factors, the early post-war literature on economic development is mainly concerned with the accumulation of capital. The amount of investment that a country can safely undertake is mainly determined by the size of current savings. Savings, thus, become a major source of financing economic development.

Long before, Lewis suggested that a central problem in the theory of economic growth is to understand the process by which a community is converted from being a 5 percent saver to a 12 percent saver... with all the change in attitudes, in institutions and in techniques which accompany the conversion. In developing countries this approach still holds good and is an integral part of development models which typify the development process, such as Lewis model of development with unlimited supplies of labour. In this context it can be argued that any device which promotes saving and capital formation should be made a basic ingredient of resource mobilisation effort. Resources mobilised through savings greatly minimise a country's dependence on such of the fiscal and monetary tools which have high economic costs or which lead a country into one or the other type of vicious trap.

When the question of promotion of savings arises and more importantly when a directed flow of the same is required, there is nothing more appropriate than an expenditure tax. Its treatment of saving is well known. If an expenditure tax actually leads to an increase in private savings, then this in itself would release scarce resources which could be further used to support a high level of public spending. Thus, it is not necessarily true that a more progressive expenditure tax would be required, as is popularly alleged, to raise needed revenue.

In the context of zakat and expenditure tax, let us mention here the Keynesian approach which emphasises that investment is not determined by saving; on the contrary, saving is determined by investment. Saving adjusts to the level of investment desired either through increases in output if resources are unemployed or through income redistribution between low savers and high savers, if resources are fully employed. Since zakat is regarded as a charge on hoarding, it would lead perforce to employment of idle investible resources. This along with a charge on dissaving will open up new possibilities of financing a sustainable process of economic development. It is observed that “for developing Muslim countries striving for resource mobilisation for development, Islamisation provides new hope for the economy. The motivation to consume less and save more to improve one’s own economic conditions as well as economic conditions of the lesser privileged in the community comes from one’s conscience, i.e., from one’s religion. It cannot be denied that all policies of development and resource mobilisation of developing countries fail because they lack motivation on the part of individuals and because their policies are hardly in harmony with the social and religious norms of the individuals. Thus Muslim countries have nothing to fear from the process of Islamisation on macroeconomic front”<sup>48</sup>.

One reservation against choosing the expenditure tax could be that it may not increase net national savings because it involves merely a transfer of private voluntary savings to forced saving at the disposal of government. But this view may not be always correct. Even if it is true, such a tax would be still desirable to effect a transfer of resources to socially and economically beneficial projects<sup>49</sup>.

## 10. Expenditure Tax and Control of Inflation

In economic terminology a persistent rise in prices is known as inflation. A very high rate of inflation is socially costly, politically demoralising and economically wasteful. It is generally argued that political stability and the very survival of democracy would be threatened once inflation rate crosses the single digit level. This argument is justified by pointing out to the disaster that it brought in Germany, Chile, Argentina, Brazil and many Afro-Asian countries. Unless inflation is controlled effectively, any attempt in the direction of social justice, economic equality and political stability would prove futile.

Control of inflation demands a multi-frontal attack, requiring a suitable combination of income, monetary and fiscal policies. In the context of developing countries it is usually pointed out that with the twin aims of providing sufficient credit for productive purposes and keeping the cost of credit at relatively low levels, the policy alternatives available are quite limited. Thus, fiscal policy assumes a special significance. At the same time it is also realised that the conventional fiscal tools are proving ineffective. For example, there is very little room, if any, for a further increase in income tax rates because at present the trend is in favour of low rates. Around the world different governments have realised the efficiency cost of high tax rates. They have also taken a serious note of tax evasion, tax-gamesmanship and rearrangement of personal and business affairs with a view to evade different taxes. On the one hand, with regard to the equity and efficiency considerations, governments find it difficult to raise more revenue through different taxes, on the other they also find it equally difficult to

reduce public expenditure for fear of the loss of popular vote and support. Thus, there are limited chances of controlling public expenditure and monetary expansion might continue unabated. Similarly, public borrowing has also turned out to be less effective in controlling inflation. There are many reasons, for example, interest rate is normally less competitive; period of repayment is fairly long and by the time loans mature the interest component of loans stands to lose much of its real value, borrowing programme would be self-defeating if it is met out of previously accumulated balances<sup>50</sup>. After some time governments might find it difficult to repay loans and might well fall into a debt trap.

With these limitations in mind we have to identify a fiscal tool whose anti-inflationary potential, for one reason or the other, has not been realised so far. This search would not take us too far for the reason that this less explored fiscal tool is but an expenditure tax.

Friedman<sup>51</sup>, Poole<sup>52</sup> and Tobin<sup>53</sup> have emphasised the anti-inflationary potential of an expenditure tax. These scholars argue that an expenditure tax is on the borderline between fiscal tools and direct action such as rationing of goods. It is contended that requiring consumers to consume goods in a specified amount and proportion is wasteful since individual tastes and needs differ. This can be eliminated by fixing not the specific commodities but aggregate amount of commodities and services that an individual may purchase, leaving him free to purchase items of his choice. Extended to the whole range of commodities and services this involves rationing of purchasing power. An income tax with all its income withdrawal effect needs to be supported by a well planned programme of compulsory savings. An expenditure tax curbs excessive spending and also encourages taxpayers to save more. Even taxpayers with excess purchasing power would find their hands tied to an extent. An expenditure tax immobilizes purchasing power. This particular advantage is missing in other fiscal tools. An expenditure tax would be able to cope with the situation of “depression level supplies and prosperity level incomes” more effectively than income and sales taxes combined together. Its impact would be felt not only in terms of reduced consumption but also in the easier availability of scarce resources to meet the requirements of reconstruction and rebuilding of an economy. Arguments on similar lines were advanced by Poole and Tobin. Even Musgrave, a staunch supporter of the accretion-type income tax, has admitted to the anti-inflationary potential of an expenditure tax<sup>54</sup>.

Control of inflation and price stability are more important in a Muslim country than in a non-Muslim country. Besides traditional arguments favouring price stability, three more fundamental reasons to control inflation can be advanced in the context of peculiar requirements of Islamic *shariah*. First an Islamic economy does not permit interest-based transactions. It is normally argued that the instrument of interest to some extent might have compensated for the fall in the purchasing power of money. Secondly, depreciation in the value of a monetary unit is not desired from the *shariah* view point. Third, zakat base, *nisab* and zakat payment are all traditionally expressed in real terms. Even at present a “critical minimum reference” to *shariah* prescriptions is absolutely necessary and hence the need for price stability is felt greatly.

## 11. Expansion of Zakat Base

Basically, an expenditure tax is a saving-promoting device because here savings qualify for a hundred percent deduction from the income reported for the tax purposes. Savings might assume different forms such as bank deposits, shares, investment in plants, real estate, participatory loans and investment in other financial and non-financial instruments. This would undoubtedly expand zakat base because fundamentally zakat covers different types of productive capital. No other direct fiscal device but an expenditure tax would help promote saving and thereby strengthen zakat base, to the advantage of both state and individuals. To the extent savings are promoted their impact would be directly felt on zakat front reflecting in terms of expansion of zakat base. Since an expenditure tax provides a very strong incentive to save, people would save more than before and they would have to, therefore, pay more zakat than before.

It can be argued that it is not necessarily true that a '*sahibu'n-nisab*' should pay zakat on gold, silver, articles of trade, cattle and on agricultural produce because these are the only recognised forms of wealth in shariah. Undoubtedly, these were there in the past and continue to remain at present too. But with time many more attractive forms of wealth have appeared and their number continues to increase on account of a revolution in the areas of trade, transport and telecommunications. According to the Islamic approach and holding of financial and non-financial assets which is above *nisab*, completes one year and is free from debt would come under the purview of zakat.

Under an expenditure tax regime it is required that all investments should be recorded so as to claim a 100 percent deduction from chargeable expenditure<sup>55</sup>. Unrecorded transactions are treated on cash-flow basis and, therefore, these would get taxed at prevailing rates. Since a 100 percent allowable deduction is tagged to the recorded savings, the expenditure taxpayers would get a strong incentive to record different types of savings and investments and hence the zakat base would expand. This incentive could be further stimulated when amount paid in zakat also qualifies for a 100 percent deduction from taxable income or expenditure.

Here we can anticipate an objection that a system, where zakat and expenditure tax operate side by side, would be on a self-destruct path for the reason that the levy of zakat would cancel incentives to save as provided under the expenditure tax regime. Therefore, we should not expect promotion of saving and investment, capital formation and thereby high growth rates.

This criticism is not well-founded. It is countered that on the contrary, imposition of zakat would lead perforce to employment of assets which in the absence of zakat would have remained idle. This effect of zakat can be understood in the context of a circular relationship between zakat and increased investment and zakat and increased transfer payment. One set of forces would strengthen supply factors and the other would stimulate demand forces. Hence, from the view-point of both demand-management and supply-side approaches, zakat would be an effective instrument not only for an equitable distribution of income and wealth but also for an efficient allocation of resources.

It is quite possible that the argument developed above could be challenged maintaining that the curtailed expenditure lead to larger saving but not higher investment. The result might be a fall in income hence eventually a fall in zakat revenue<sup>56</sup>. This is not true. It can be asked: What eligible zakatpayers are going to do with large savings when it is feared that zakat on an annual basis would eat up their savings. Would they remain silent and passive spectators to a gradual decline in their balances? How would they react to a situation where things might get worsened on account of a persistent fall in the value of monetary unit? It can be maintained that a fear of gradual decline in savings which is further compounded by the fear of decline in the real value of money would force savers to find out suitable avenue of investment. Supposing that the investors are not shrewd enough to understand intricacies of stock market so as to personally undertake investment, they could resort to investment in stock through secondary sources, i.e., financial institutions, investment companies, mutual funds, unit trusts, etc. Therefore, it can be safely assumed that investment would increase following an increase in savings.

It should be noted that basically zakat is not an impost on yield/return on investment. Therefore, business and investment considerations would be more important than zakat considerations because it is paid at a flat rate of 2.5 percent only. Zakat would have cancelled incentives to save as provided by the expenditure tax treatment of savings had it been on return from investment. This would have required a higher zakat rate to satisfy the equal-revenue condition.

It should not be ignored that the assets on which zakat is paid are subject to a “divine multiplier”<sup>57</sup>. One must also remember that the human economic behaviour is conditioned by the relevant value system. Altruism is built in the Islamic value system which varies directly with the strength of “*iman*”. A true Muslim gets as much satisfaction by giving as he gets by consuming, since giving qualifies for Allah’s pleasure. As against conventional economic rationality (substitution effect) it is not difficult to find Muslims who earn to save more (economic effect) to pay more zakat and thereby earn more merit in the life hereafter (merit effect)<sup>58</sup>. In this sense the notion of altruism, including zakat and other payments, is not considered as a tax on savings but rather a forceful and effective incentive to save. “If this is valid, expenditure in the way of Allah will also not be expected to reduce savings, since it may increase effort to earn more income”<sup>59</sup>. Further, it should be also noted that under the Islamic framework the institution of zakat would make it necessary for the owners of wealth “to increase their saving by at least the amount of zakat paid, the prohibition of interest makes it necessary for them to minimise resources held in the liquid form”<sup>60</sup>.

## **12. Developing a Workable Model of an Expenditure Tax for Muslim Countries: An Outline**

Howsoever efficient and equitable the expenditure tax treatment of savings might be, it would be highly objectionable when extended to Muslim countries because in an expenditure tax regime interest based-transactions are permitted and attractiveness of various saving plans greatly depend upon tax treatment of interest earned. Islam does not permit interest in either period one or period two. Therefore, the proposal favouring an expenditure tax needs to be rewritten as under.

### 12.1 *Profit and loss sharing*

A scheme of profit and loss sharing (PLS) should replace the instrument of interest. Research in the area of interest free banking indicates that in Muslim countries financial institutions can be successfully run on the PLS basis. Therefore, the question of different saving plans losing their attractiveness in absence of the instrument of interest will not arise. Further, it should be also noted that responsiveness of saving is not limited only to interest permissibility in secular countries or PLS margin in Muslim countries but also on their tax treatment. Minimum tax, or possibilities of avoiding tax payment altogether would also contribute towards their attractiveness. In fact the amount saved in tax is actually a premium on savings.

### 12.2 *Categorisation of saving schemes*

In order to realise numerous advantages of an expenditure tax and for the sake of administrative convenience, it is necessary to categorise different saving and investment schemes into two broad plans, say, X1 and X2 types of saving plans. X1 type of savings can be defined as those which are contributed to or invested only in government approved form and therefore 100 percent tax deductible. Any saving plan other than X1 would be treated X2. Contributions to this plan would be also fully tax deductible provided these are recorded fully for accounts purposes and reported fully for tax purposes.

### 12.3 *Creation of national equity fund*

It would be required for the government in a Muslim country to create a National Equity Fund (NEF) wherein contributions would be made under X1 scheme. For the sake of simplicity and administrative convenience it is suggested that the existing saving and investment plans on which tax incentives are provided should be administered by NEF. Studies have reported results of simulations which suggest that permitting unlimited tax deductibility for savings under a progressive personal income tax could have a more favourable impact on total personal savings and capital accumulation<sup>61</sup>.

The NEF would perform following important functions:

1. It would undertake investment on behalf of its numerous contributors and share profit and loss with them. There are a number of examples of investment / finance companies which undertake investments on behalf of their contributors who have no or a very limited knowledge to understand intricacies of stock market.
2. It would be authorised to deduct zakat at source on the capital of each contributor provided it is above *nisab* and it has completed one year under the administration of NEF. Regarding debts it can be said that no deduction would be allowed in respect of debts which are incurred in the case of assets not liable to zakat.
3. The NEF, adhering to the expenditure tax principle, would also collect a tax on withdrawal after a stipulated period. No tax, except a withdrawal tax, would cover dissaving. The need for a withdrawal tax would be still more clear when we examine the case of a hypothetical taxpayer in the following paragraphs.

#### 12.4 Monitoring of X2 savings plan

About X2 savings plan, which is supposed to be a conglomeration of saving and investment schemes, it can be said that there could be a large number of savers/investors who would like to invest their surplus funds independently in one or more profitable business ventures. For their investment plans they need not approach to NEF. Here it is proposed that in Muslim countries it should be made compulsory for all companies to deduct zakat at source on behalf of their contributors provided shariah conditions are satisfied. The monitoring of zakat base (following which the computation of consumption) would be possible because in the year preceding zakat payment, they had asked for a 100 percent deduction of the amount contributed to the X2 savings plan from their income. Here tracking of sale of assets accumulated tax free would be also possible because in the following year zakat will not be paid on them. Further, their sale proceeds would be included in the gross income in the year of sale and taxed accordingly.

Let us examine a question as to how an expenditure tax would be administered in a scenario where income/wealth tax and zakat are operative. For this we take the help of following hypothetical example<sup>62</sup>. It should be noted that our starting point would be income, be it an income tax or an expenditure tax.

##### Statement A: Income

|     |  |          |
|-----|--|----------|
| 1.1 |  | \$10,000 |
|-----|--|----------|

##### Statement B: Net of Purchase and Sale of Investment Assets

|     |  |         |
|-----|--|---------|
| 2.1 |  | \$3,775 |
|-----|--|---------|

##### Statement C: Net of Borrowing and Lending

|     |  |         |
|-----|--|---------|
| 3.1 |  | \$ -950 |
|-----|--|---------|

##### Statement D: Net of Cash Holding and Bank Deposits

|     |  |        |
|-----|--|--------|
| 4.1 |  | \$ 175 |
|-----|--|--------|

##### Statement E: Expenditure

|     |                                      |         |          |
|-----|--------------------------------------|---------|----------|
| 5.1 | Income (1.1)                         |         | \$10,000 |
| 5.2 | Net balance from Statement B         | \$3,775 |          |
| 5.3 | Net balance from Statement C         | \$ -950 |          |
| 5.4 | Net balance from Statement D         | \$ 175  |          |
| 5.5 | Total (sum of items 5.2 through 5.4) | \$3000  |          |
| 5.6 | Expenditure (5.1 minus 5.5)          |         | \$ 7,000 |

##### Statement F: Net Wealth

|     |   |         |          |
|-----|---|---------|----------|
| 6.1 | Net wealth as of the last day of preceding taxable period |         | \$12,000 |
| 6.2 | Net balance from Statement B                              | \$3,775 |          |
| 6.3 | Net balance from Statement C                              | \$ -950 |          |
| 6.4 | Net balance from Statement D                              | \$ 175  |          |
| 6.5 | Net wealth as of the last day of present taxable period   |         | \$15,000 |

In the above example where a wealth tax is imposed at the same time as an expenditure tax and most of the taxpayers subject to one tax are also subject to the other, an expenditure tax would impose little additional compliance burden as feared otherwise. A direct tax on wealth will supply all the information needed for the calculation of gross expenditure, which is being approached indirectly.

From zakat view point what is of interest to us is the change in the net wealth. As on last day of preceding taxable period the net wealth stood at \$10,000. After the introduction of an expenditure tax some additional information regarding direction, flow and composition of savings would be furnished by the taxpayer. He would do so to claim tax deduction. In our example the reported change in the net wealth as on last day of present taxable period stands at \$ 13,00. Following this more zakat would be collected.

Now the question is: Should we impose zakat and wealth tax on the same base and at the same time? Strictly from shariah view point it can be argued that all those taxes, including a wealth tax, which duplicate zakat should be avoided altogether<sup>63</sup>. In our model the revenue loss following the abolition of wealth tax would be greatly offset by the imposition of a withdrawal tax.

It is entirely a different question that along with zakat a wealth tax is also required when either revenue need is great or inequalities are so wide enough to warrant imposition of two levies on the same base. What, however, is eminently clear from the above example is that when an expenditure tax is operative, information obtained for one levy could be conveniently used for cross checking the other. Any understatement of one would lodge taxpayer in a situation where he would be over-reporting the other.

To conclude it can be maintained here that the above scheme would help to promote and strengthen the zakat base. It would also support in releasing scarce resources for more productive uses and to that extent governments' dependence on non-tax tools, particularly public borrowing and deficit financing, would be less. It is high time that the present day Muslim countries should give a serious thought to the introduction of an expenditure tax. They should not look at the experiments made in other countries but make bold decisions. Let other countries follow their examples because basically *Islam is not a borrower but a lender of ideas*<sup>64</sup>.

### 13. Legal Basis in Shariah

Regarding the legal basis in shariah for levying an expenditure tax it can be said that some policy options can be derived from the Quran, traditions of the Prophet, conduct of the righteous caliphs and from the writings of doctors of Islamic theology. In this context it can be quoted from the Quran<sup>65</sup>: "Oh ye people, eat of what is good on earth, lawful and good and do not follow footsteps of evil one for he is to you an awed enemy". The Quran warns that spending spree should not take us away from the guided path and that we should not step onto the path of evil. This is made clear in other verses<sup>65</sup>: "Squander not (your wealth) in a manner of spend thrift. Verily spend thrifts are brothers of evil one and the evil one is to Lord (Himself) ungrateful" ... "eat up not your property amongst yourselves in vanities" ... "waste not by excess for God loveth

not wasters”. The Almighty Allah has condemned those who waste their wealth in an extravagant fashion without any purpose: “He may say (boastfully) ‘wealth I have squandered in abundance’. Thinketh he that none beholdeth him”. On the contrary what the Almighty favours most is moderation in spending. He gives good tidings to the righteous who are those “when they spend are not extravagant and not niggardly but hold a just balance between these (extremes)”.

The Quranic aversion to ostentatious consumption found its highest possible manifestation in the life of the Prophet. He led an irreproachable simple life, devoid of any pomp and show. His righteous caliphs and other companions too led an exemplary simple life, devoid of any element of ostentation. The Prophet is reported to have asked his followers that their personal food, dressing and housing should be simple and that the vulgar display of wealth should be avoided. “The Prophet himself offered an example of an ideal consumer behaviour. He led a simple and rough life. His companions adopted his model and in this way simplicity and low consumption became values of Islamic society. The Prophet dissuaded from a life of *tanaum* (luxury) and forbade consumption of all those things which lead to such a life style. Significant example of luxury in those days were squandering of wealth on gambling and drinking, ostentatious dresses (mostly silken wears by men) paintings and portraits, rearing of dogs and precious metal utensils”<sup>66</sup>. Amar bin Shuaib reported on the authority of his great grandfather that the Messenger of Allah said: “Eat and spend as *sadaqa* (in charity) and wear without squandering and pride”<sup>67</sup>. It has appeared in another tradition of the Prophet that he expressed his aversion when he saw a high domed building constructed by one of the ansar. His displeasure continued till the concerned owner of building demolished it. Upon the demolition the Prophet said: “Every building is a misfortune for its owners except what cannot be done without it”<sup>68</sup>.

At the time of deputation as the governor of Yemen, Maaz bin Jabal was advised by the Prophet to refrain from luxurious living<sup>69</sup>. Umar too was very particular about the life style of people in general and governors in particular. He is reported to have instructed his governors that they should not construct high rise buildings<sup>70</sup>. The governor of Kufa Saad bin Abi Waqqas had constructed a palace for his personal use on account of which it had become difficult for people to contact him. When it was brought to the notice of Umar, he sent Muhammad bin Muslimma with instructions to burn the palace. He did accordingly<sup>71</sup>. During the period of Umar, settlements were developed at Kufa. Houses were constructed using bamboos and reed which unfortunately caught fire. Saad bin Abi Waqqas sought his permission to construct houses using bricks. Umar granted permission on the conditions that the people of Kufa would not construct high rise buildings and no one would own more than three houses<sup>72</sup>.

It happened during the period of Usman that a few persons were found indulging in rearing and flying pigeons and playing marbles. He assigned to one person the job of cutting wings of pigeons and destroying marbles<sup>73</sup>. In Tadhkirah of Hamdun the following is reported about Abu Dharr that when Muawiyah built his green palace at Damascus he asked Abu Dharr what he thought of it. Abu Dharr replied: “If thou hast built it with public money thou art a traitor, if with thy own thou art a squanderer”<sup>74</sup>.

It does not, however, follow that Muslims should lead a life of misery. There are traditions to the effect that the Prophet pointed out: "Among items of human well being are a spacious house, a good neighbour and a good conveyance". A shortened version of another tradition is that the Prophet saw one of his companions wearing coarse clothes. The Prophet remarked: "When Allah gives you money, evidently, His bounty must be visible from your person"<sup>75</sup>. Thus, what Islam has so heavily denounced is wasteful and ostentatious consumption expenditure.

Several commentators of the Quran thought it necessary to distinguish *tabzir* (extravagance) from *israf* (prodigality). In shariah and *fiqhi* terminologies *tabzir* relates to that form of spending which is not commanded by the Almighty. Therefore, any person indulging in *tabzir* is considered as a sinner. It could be on those illegal things and activities which are not permitted by the shariah. It is considered as distinctly forbidden<sup>76</sup>. It appears in the Quran: "Verily spend thrifts are brothers of evil ones; the Evil One is to his Lord (Himself) ungrateful"<sup>77</sup>. It can be derived from this verse that an Islamic state has every right to curb such spendings by resorting to direct action and force, where necessary.

By *israf* is meant spending by excess on legally permissible items without expecting or realising additional gains. Such unproductive spending is considered as waste of resources. It is disliked by the Almighty Allah. It appears in the Quran that: "O Children of Adam! Wear your beautiful apparel at every time and place of prayer: eat and drink: But waste not by excess, for God loveth not the wasters"<sup>78</sup>. At another place it is pointed out that faithful are "those who when spend are not extravagant and not niggardly, but hold a just (balance) between those (extremes)"<sup>79</sup>.

Currently, many new forms of luxury have appeared. Consumerism is order of the day. Aggressive advertisement and impulsive publicity have become key features of the modern marketing. There is all possibility that innocent consumers might be swayed away. In the context of modern day life different forms of wasteful and luxurious spending should be redefined. There is no reason why a person should not be prevented from owning a fleet of cars; constructing palatial buildings; cracking fireworks during festivals, etc. By applying the criterion which was used some 1400 years ago it is apparent that we cannot measure the present day lifestyle in the context of abundance of resources and advances in the area of building technology. However, we can draw certain guiding principles that moderation and economy should be favoured; members of the society found spending by excess should be restricted or penalized. Therefore, "keeping in view the overall spirit of the shariah, its value system and the distribution of wealth in the society, the level of *tanaum* could be defined from time to time..... The life of *tanaum* is discouraged in Islam both by educating people and by public action if necessary. For example, the state may discourage or even ban the production and import of such articles which by a social consensus lead to a life of *tanaum*. In still another case the state may apply the classical instrument of *hajr* (interdiction) to forestall a luxurious behaviour"<sup>80</sup>.

The concept of *hajr* is derived from the Quranic instructions of forbidding minor orphans to have an access to their own resources until they attain maturity. It appears in the Quran: "To those weak of understanding, make not over your property which God

hath made a means of support for you..... Make trial of orphans until they reach the age of marriage; if then ye find sound judgment in them, release their property to them, but consume it not wastefully, nor haste against their growing up”<sup>81</sup>.

An Islamic state can regulate personal spending when it is found that a person is indulging in extravagant expenditure. It should be realized that wealth, property rights, etc., are granted to men so that these could help them achieve higher goals of life. However, on account of wasteful expenditure not only personal interest of an individual is adversely affected but collective interest of other people too gets victimised. The Islamic jurisprudence regards a person as anile, oblivious and perfidious who fritters his wealth. His dealings and transactions, including transfer of property, need to be controlled and regulated<sup>82</sup>. In this regard all four schools of Islamic jurisprudence hold an unanimous view. Authoritatively the Hanafi School favours interdiction even though Imam Abu Hanifa is of the view that it is incorrect to regulate spendings of a matured and sensible person who is found indulging in wasteful expenditure<sup>83</sup>. However, other jurists, including a number of Hanafi jurists, believe in interdiction on account of extravagant expenditure<sup>84</sup>.

Imam Sarakhsi also writes: “Anility means acting against the exigencies of shariah. It also means submitting to hedonism and defying the limits of human reasoning. The shariah in general approves bounteous spending. Liberal spending on sanctimonious and benevolent activities is also appreciated. However, spending by excess on these (noble and pious) activities is undesirable from the view point of established convention and shariah too”<sup>85</sup>. A further study of different forms of undesired spending and instructions regarding interdiction can be made by referring to primary sources on *fiqh* (jurisprudence). Different forms of regulatory and interdictory measures can be devised taking into account requirements of the time. These can be: restricting a person from spending on certain items; obtaining compulsorily a prior permission from the state in matters pertaining to transfer of property rights, etc.

The nature and scope of these measures could be decided according to the requirements of time and society. In this context, the Prophet’s displeasure over domed dwelling, Umar’s instructions to his governors prohibiting them from constructing high rise buildings and his fixation of a ceiling on the number of houses to be owned by a person, Usman’s instructions to stop fun and mirth, etc, could be taken as the prototypes of modern fiscal, monetary and direct controls to manage the economy on more efficient lines. This provides a room for the state intervention and introduction of an expenditure tax.

The expenditure tax could be viewed as one among many other means of regulating spending power so as to minimise “*israf*”. This coupled with other regulatory measures would help release scarce resources for more important developmental works and projects. It is necessary that a government should be very clear about its priorities because then only it can try alternative tools of fiscal management. This should be, however, borne in mind that the case in favour of an expenditure tax is being developed to control wasteful ostentatious expenditure; minimise inequities, inefficiencies and distortions due to the defective definition and mismeasurement of income as an index of ability to pay and more importantly to expand zakat base.

## Notes

1. **Imtiaz, I.A.**, 1989, "Introduction" in I.A. Imtiaz and others (eds.), *Management of Zakah in Modern Muslim Society*, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, p. 19.
2. **Chapra, M.U.**, 1992, *Islam and the Economic Challenge*, The Islamic Foundation, Leicester, p. 272.
3. With the passage of time many more new forms of productive assets and sources of earnings have come into existence upon which zakat can be levied. For a detailed discussion one can refer to **Yusuf al-Qardhawi's** celebrated work *Fiqh al Zakah*.
4. Zakat on agricultural produce is to be paid immediately after harvest as it appears in the Quran: "... and pay the due thereof upon the harvest day" (6:141). One can visualise multiple cropping and, therefore, zakat has to be paid upon each harvest. For its economic implications please refer to **Sayed Afzal Peerzade's** (1995) "Islamic Perspective of Agricultural Taxation", *Azad Academy Journal*, January 1-31, pp. 5-14.
5. The Quran 2:219.
6. **Abu Isa al Tirmidhi**, *al Jamih al Saheeh, Bab ma ja' Anna fil Mal Haqqan siwa al Zakah*.
7. **Chapra, M.U.**, 1992, *Islam and the Economic Challenge*, op.cit., p. 271.
8. **Siddiqi, M.N.**, 1996, "Place for Additional Levies in Islamic Shariah", in Sayed Afzal Peerzade (ed.), *Readings in Islamic Fiscal Policy*, Adam Publishers, Delhi, pp. 54-68.
9. **Al-Qardawi**, 1992, *Economic Security in Islam*, Rendered into English by Muhammad Iqbal Siddiqui, Islamic Book Service, Delhi, pp. 33-65.
10. **Hamidullah, Mohammad**, 1988, *Islami Riyasat*, Dar ul Quran, Delhi, pp. 38-69.
11. **Siddiqi M.N.**, 1978, *Islam ka Nazria-e-Milkiat*, Markazi Makatab-e-Islami, Delhi, pp. 391-454 and 509-529.
12. **Faridi, F.R.**, 1984, "Zakat and Fiscal Policy", in Khurshid Ahmed (ed.), *First International Conference on Islamic Economics: Selected Papers*, Amar Prakashan, Delhi, pp. 119-130.
13. **Chapra, M.U.**, 1992, *Islam and the Economic Challenge*, op.cit., pp. 295-299.
14. **Hasanuzzaman S.M.**, 1993, "Islamic Criteria for the Distribution of Tax Burden: The Mix of Direct and Indirect Taxes and the Offsetting Function of Zakat", *Journal of Islamic Economics*, Vol. 3, No. 1, pp. 17-32.
15. **Siddiqi, M.N.**, op.cit., pp. 509-529.
16. Three popular tax paying units are: Individual, family and company, and popular tax bases are income, consumption and wealth.
17. **Goode, Richard.**, 1977, "The Economic Definition of Income" in Joseph Pechman's (ed.), *Comprehensive Income Taxation*, Brookings Institution, 1977, pp. 1-36.
18. For a further discussion encompassing a two period model, one can refer to David Bradford's papers, especially "Case for a Personal Consumption Tax", in Joseph Pechman's (ed.), *What Should be Taxed: Income or Consumption*, The Brookings Institution, Washington, 1980, and "The Choice Between Income and Consumption Taxes" in *Tax Notes: Special Report*, August 23, 1982.
19. The idea of common wealth or common pool is attributed to Hobbes. Probably the world came to know about this idea of Hobbes only from Nicholas Kaldor who has quoted him in his highly acclaimed book *An Expenditure Tax*, George Allen and Unwin, 1955.
20. It should be remembered here that poor people are not supposed to pay direct tax, it be an income tax or an expenditure tax. Instead, in developed countries they would be beneficiaries of a well developed social security system and in Muslim countries they would be benefited under a scheme of negative income tax, i.e., governments transferring money to poor regularly.
21. For a detailed discussion of issues such as these one can refer to Sayed Anzal Peerzade's *Expenditure Tax in India: Feasibility Problems and Prospects*, Anmol Publishers, Delhi, 1990.
22. **Chapra, M.U.**, 1992, *Islam and the Economic Challenge*, op.cit., pp. 125-126.

23. For an overview of literature please see Sayed Afzal Peerrzade's *Expenditure Tax in India: Feasibility Problems and Prospects*, *op.cit.*, pp. 105-166.
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35. **Chelliah Raja J.**, 1980, "Case for An Expenditure Tax", *Economic and Political Weekly*, January 26, 1980.
36. **Fisher, Irving.**, 1939, "Double Taxation of Savings", *op.cit.*
37. **James, Simon** and **Christopher Nobes**, 1978, *The Economics of Taxation*, Philip Allan, p. 65.
38. In Muslim countries the instrument of interest would get replaced by a system of PLS.
39. **Das Gupta A.**, 1988, "Personal Taxation and Rates of Return to Private Financial Savings in India", NIPFP, New Delhi, 1987, and also "A New Measure of Fiscal Privilege", *Public Finance Quarterly*, Vol. 16.
40. **Kaldor, Nicholas.**, 1980, in his comments on William D. Andrew's paper on "A Supplemental Expenditure Tax" in Joseph Pechman (ed.), *What Should Be Taxed: Income or Expenditure*, Brookings Institution, Washington D.C., p. 151.
41. There is a vast literature on these issues. One can refer to *Blueprints for Basic Tax Reform*, *op.cit.*, *Meade Committee Report*, Institute of Fiscal Studies George Allen and Unwin, London, 1978, and *Lodin Commission Report*, *op.cit.* Besides numerous of Irving Fisher, David Bradford and William Andrews deserve a special mention.
42. Information Report: "Expenditure Tax: Concept, Administration and Possible Applications", *Advisory Commission on Intergovernmental Relations*, Washington, D.C. 1974, p. 17.
43. **Siddiqi M.N.**, *op.cit.*, p. 210.
44. **Khaldun, Ibn.**, 1978, *Al Muqaddimah*, Urdu Translation by Maulana Ragib Rahmani Dehlvi, Vol. 1, Iteqad Publishing House, New Delhi, pp. 426-28.
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46. **Siddiqi M.N.**, 1978, *Islam ka Nazria-e-Milkiat*, *op.cit.*, p. 519.
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48. *Ibid.*
49. Here one should not ignore the effect of investment multiplier.

50. These observations hold good only in non-Islamic countries. These do not justify or support the practice of interest based transactions.
51. **Friedman, Milton**, 1943, "The Spendings Tax as A War Time Measure", *American Economic Review*, Vol. **33**, pp. 50-62.
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53. **Tobin, James.**, 1949, "Taxes, Savings and Inflation", *American Economic Review*, Vol. **39**, pp. 123-39.
54. **Musgrave, Richard A.**, 1959, *The Theory of Public Finance*, McGraw Hill, p. 250.
55. For a detailed discussion on "recorded", "unrecorded", "registered" and "unregistered" savings and investment schemes one can refer to *Blueprints for Basic Tax Reform* (1977) and *Meade Committee Report* (1978).
56. This observation is made by an expert who wants to remain anonymous. The present author would like to express his gratitude to him.
57. The Quran speaks out: "The parable of those who spend their substance in the way of Allah is that of a grain of corn. It produces seven ears and each ear yields a hundred grains. Likewise Allah gives manifold increase to whom He pleases for He is All Embracing, All Wise. Those who spend their wealth for the cause of Allah and afterwards make not reproach and injury to follow that which they have spent, their reward is with their Lord and there shall be no fear upon them, neither shall they grieve" [2:261-62].
58. **Peerzade, Sayed Afzal.**, 1991, "The Idea of Merit Effect: Islam's Contribution to Economics", *Journal of Objective Studies*, Vol. 3, No. 1, pp. 1-22.
59. **Sadeq, Abul Hasan M.**, 1992, "Development Finance in A Islamic Economy: Domestic Resources", in Sadeq Abulhasan M. (ed.), *Financing Economic Development: Economic and Mainstream Approaches*, Longman, Malaysia, . 15.
60. **Kahf, Monzer.**, "Saving and Investment Functions in a Two Sector Islamic Economy", in Sadeq, Abulhasan M. (ed.) *op.cit.*, p. 53.
61. **Daly, M.J.**, and **Fadle Naquib**, 1985, "Designing a Non-Distortionary Personal Tax System for Canada", *Economic Letters*, Vol. 18, pp. 209-12. Also, **Daly M.J.**, **Gary Lastman** and **Fadle Naquib**, 1988, "The Role of Tax Deductible Savings in the Transition from A Progressive Income Tax to A Progressive Consumption Tax", *Public Finance*, Vol. 43, No. 3, pp. 351-372.
62. This hypothetical example is adopted with some minor alterations from Patrick Kelley's "Is An Expenditure Tax Feasible?", *National Tax Journal*, September, 1970, Vol. XXIII, No. 3, pp. 237-53.
63. **Faridi, F.R.**, 1984, "Zakat and Fiscal Policy", in Khurshid Ahmed (ed.), *First International Conference on Islamic Economics: Selected Papers, op.cit.*, pp. 121-122.
64. Muslim countries which are interested in incorporating *shariah* features into their social, economic and political framework, should not always just look at the experience of developed countries. Should we for zakat purpose also look at their experience? No, we cannot! Then why should we look at developed countries for the purpose of implementation of an expenditure tax which is supposed to play a supportive role in promoting zakat base?
65. The verses from the Quran that follow are: 2:168; 17:26-27; 4:29; 6:141; 90:6-7; and 25:67 respectively. All translation are from **Pickthal, M.** 1991, *Quranic Advices: Selections from Holy Quran*, Kitab Bhavan.
66. **Khan, Muhammad Akram.**, 1992, *Economic Teachings of Prophet Muhammad: A Select Anthology of Hadith Literature on Economics*, Oriental Publications, Delhi, p. 75.
67. **Khan, Muhammad Akram.**, *op.cit.*, p. 82.
68. *Ibid.*
69. **Siddiqi M.N.**, 1978, *Islam ka Nazria-e-Milkiat, op.cit.*, p. 226.
70. **Siddiqi M.N.**, 1978, *Islam ka Nazria-e-Milkiat, op.cit.*, p. 221.
71. **Tabari, Abu Jaffar Muhammd bin Jarir**, *Tarikh*, Leiden Brill, p. 2493.
72. **Siddiqi M.N.**, 1978, *Islam ka Nazria-e-Milkiat, op.cit.*, p. 473.

73. **Tabari**, *op.cit.*, p. 3027.
74. **Khudabaksah, S.**, 1981, *Politics in Islam*, Idharah-e-Adbiyat-e-Delli, p. 32. For a scintillating account of Abu Dharr one can refer to A.J.Cameron's, 1973, *Abu Dharr al-Ghiffari: An Examination of His Image in the Hagiography of Islam*, The Royal Asiatic Society.
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77. The Quran 17:27.
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83. **Qazizada, Moula Shamshuddin Ahmed**, *Takmila Fateh al-Qadir*, Vol. 8, p. 314. Also, Sarakhshi, *al-Mabsut*, Vol. 24, p. 155, quoted by **Siddiqi M.N.**, 1978, *Islam ka Nazria-e-Milkiat*, *op.cit.*, p. 467.
84. **Al-Jaziri, Abdul Rahman**, *Al-Fiqah, ala al madhahib al arba'a*, quoted by M.N. Siddiqi, *op.cit.*, p. 478.
85. **Sarakshi**, *al-Mabsut*, *op.cit.*, Vol. 24, p. 155, quoted in **Siddiqi M.N.**, 1978, *Islam ka Nazria-e-Milkiat*, *op.cit.*, p. 467.

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## ضريبة الإنفاق في النظام المالي الإسلامي العام

السيد أفضل بيرزاده

مركز الدراسات الإسلامية

جامعة هاشم بير - بيجاپور - الهند

**المستخلص:** يحاول البحث تبرير فرض ضرائب الإنفاق في البلدان الإسلامية لأن ضريبة الدخل، ولو كانت منبعاً جيداً للموارد، فإن تطبيقها محاط بمشكلات عديدة - وقد أثيرت الشكوك حول ملائمة ضريبة الدخل على الأفراد لذا فإن ضريبة الإنفاق تعد بديلاً حسناً لضريبة الدخل - ويرى الباحث أن ضريبة الإنفاق على الأشخاص سوف تلي حاجات البلدان الإسلامية على نحو أكثر كفاءة لأنها تنسجم مع طبيعة النظام الإسلامي. وسوف تقوى مركز الزكاة والضرائب المباشرة الأخرى، كما تساعد في تمويل التنمية الاقتصادية لأنها تكبح التضخم، الأمر الذي يؤدي إلى الاستقرار في مستوى الأسعار، كما أنها توسع قاعدة الزكاة بالزيادة الحاصلة في الادخار نتيجة فرض ضريبة الإنفاق. ولتحقيق هذه المصالح يحاول البحث إيجاد نموذج لضريبة الإنفاق ينطوي على المواصفات الشرعية - ويأخذ في الاعتبار المشاركة في الأرباح، وتصنيف صيغ الادخار وتنظيم صندوق الأسهم للاكتتاب العام.