

## **ZAKAT AND PRINCIPLES OF TAXATION: EQUITY, A COMPARATIVE ANALYSIS WITH TAXES**

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### **ABSTRACT**

Zakat is an efficient mechanism of wealth redistribution allowing the transfer of wealth from those having excess resources to those in need with the aim of achieving social justice. Thus, at least from this perspective, Zakat can be compared to taxes. Considering Zakat as a form of taxation, this paper attempts to apply the principle of equity and the associated criteria, elements and issues to Zakat. The paper demonstrates that the principle of equity, as envisaged in the context of taxation, is relevant for the purposes of Zakat since the latter: (i) accepts the ability to pay as a criterion for equity, (ii) applies horizontal equity and (iii) embeds a mechanism of self-compliance that tackles avoidance and evasion. The paper also demonstrates that Zakat outperforms taxes as regards the implementation of the principle of equity due to its better ability to address the issues that are generally associated with this principle, including determining and measuring equity, addressing avoidance and evasion and catering for inflation.

**Keywords:** Zakat, Tax, Equity, Fairness, Ability to Pay, Avoidance

### **1. INTRODUCTION**

Zakat has a double nature. It is an act of worshiping in the same way as prayers, fasting and pilgrimage, etc. and, thus, is addressed in Islamic jurisprudence (fiqh) under the chapter of “Ibadat” (acts of worshipping). It is also the key component of the Islamic fiscal and social welfare system (Al Qaradaoui, 2006), and, as such, it is addressed as a financial obligation of Muslims towards the sovereign/state.

Comparing Zakat to tax may lead to different outcomes, depending on the area of focus in the nature of Zakat. If the latter is considered only as an act of worshiping, fundamental differences will appear as a result of its distinctive features that clearly differentiate it from tax. These include notably the source of its rules (viz. divine revelation), the (relative) immutability of its features, its specific uses and its overall objective (that is to purify one’s self and wealth (Al Qaradaoui, 2006)).

On the other hand, if we look beyond the religious character of Zakat and focus on its nature as a fiscal tool in the hands of the Muslim state, we will find that it shares with tax some important features that make them comparable. First, they share the same objective, that is to achieve social justice. Like tax, Zakat allows transferring financial resources from those who have an excess to those who are in need (Kahf, 1989). Also, in a society where Zakat is enforced by public authorities, Zakat would be similar to tax because both will be mandatory levies charged by the State for no specific or direct consideration to achieve certain economic and social objectives (Al Qaradaoui, 2006).

Therefore, at least from this perspective, it may be expected that the principles that govern good taxation would have some relevance for Zakat.

These principles are based on the fundamental work of Adam Smith in his book “An Inquiry into the Nature and Causes of the Wealth of Nations” where he provided, arguably, the most important attempt to conceptualize a framework around the principles of taxation. This work has occupied central stage over the last 200 years, as it has been reproduced in some form or

shape in almost all subsequent attempts to identify the principles or criteria of a good tax system (Du Preez, 2018).

Equity was the first principle (cannon) that Adam Smith identified. It was also highlighted in most of the subsequent works on principles of taxation (Preez and Stiglingh, 2018). As a result, it has also been amongst the principles of taxation that received a great deal of enrichment and development.

The purpose of this paper is to discuss the principle of equity as considered by Adam Smith and enriched by subsequent authors, committees and organizations who were concerned with tax policy, and to explore to what extent it applies to Zakat. To this end, section 2 will provide a literature review of the topic, section 3 will discuss the principle of equity in the tax context, section 4 will provide a brief overview of Zakat and section 5 will address the application of the principle of equity to Zakat. Section 6 will be a concluding one.

## **2. LITERATURE REVIEW**

Various definitions of Zakat were given in classical fiqh. Al Ghofeili (2008) reviewed these definitions and identified their common features as follows: (i) Zakat is chargeable only if *Nisab* (i.e. a specific amount of wealth) is achieved, (ii) Zakat is due only on specific items of wealth, (iii) and Zakat must be spent on specific uses. Based on these elements, Al Ghofeili (2008) defined Zakat as “a share prescribed by Sharia in a specific amount of specific wealth for specific beneficiaries”.

Allami (2015), on the other hand, using “contemporary” tax terminology, defined Zakat as “a compulsory flat levy, which is imposed by the Quran, and its funds must be distributed to the eligible beneficiaries”.

Zakat aims at purifying its payer and his wealth (Al Qaradaoui, 2006) and gives an ownership right in this wealth to the recipient (Powell, 2009)<sup>1</sup>. This contrasts with taxes, which are considered as a forced transfer of resources that is akin to theft had not there been the political process that conferred legality to them (Stiglitz, 2015).

The principles of taxation can be traced back to as early as the year 2000 BC in Mesopotamia. Clay tablets dated from this period indicate the existence of a tax-based redistribution system (Mosa, 1995). More sophisticated principles focusing on keeping the subjects’ tax burden bearable (and limited to what is needed) were developed in ancient China around the year 500 BC by Confucius and his disciple Mencius (Du Preez, 2018).

Under the Arabo-Islamic civilization, Ibn Khaldoun’s theory of *Imran* (development), which addresses the causes of rise and decay of states and civilizations, provide very useful insights on the principles of taxation some of which are still applicable even in contemporary context. It highlights the importance of a good tax system in ensuring economic development and stability (Ibn Khaldoun, 1377) and identifies fairness and moderate tax burden as the key characteristics of such a system (Chapra, 2008).

The work of Adam Smith in his book on the wealth of nations remains the most prominent attempt to provide a comprehensive conceptual framework around the principles of taxation. It would be hard to overstate the importance of this work as it has been reproduced in some form or shape almost invariably in subsequent attempts to identify the principles of a good tax system (Du Preez, 2018).

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<sup>1</sup> A similar idea is defended by Murphy and Nagel (2002) who argue that, before paying tax, income and wealth should not (morally) be considered the property of their owners.

Adam Smith identified four cannons that should govern the design of any tax. These are equity, certainty, convenience and economy of collection.

Focusing on the first cannon, and using Adam Smith's words, equity can be explained as follows: "[t]he subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." (Smith, 1776). Smith (1776) introduced here two of the key concepts that are used today to determine what would be an equitable/fair tax. These concepts are the ability to pay and benefit. Per Smith (1776), the contribution of the subjects should be proportional to their ability to pay, which is measured by the revenues they dispose. The higher the revenue, the higher the contribution. This is the key feature of a proportional income tax.

Furthermore, in the discussion of the tax on rents, Smith (1776) accepts that the rich should pay a tax that is more than in proportion of the revenue they earn, introducing thereby progressivity, which expresses vertical equity.

Smith (1776) also alluded to the concept of benefit by linking the contribution of the subjects to the fact that the revenues they derive are earned and enjoyed "*under the protection of the state*". Musgrave (1990) qualified the combination of ability to pay and benefit in Smith's conception of equity as "an uneasy mix", as it combines two approaches that are clearly different.

This first cannon is one of the most important principles of taxation as it is linked to the concept of fairness and justice, which is enshrined in the constitution of many countries in relation to tax obligations. In the US Constitution, this is found in the fourteenth amendment under the Equal Protection Clause. It is also found in the constitutions of many Arab countries, including Egypt, Qatar and Kuwait, etc. which provide that taxes are based on "social justice" and may be levied only by way of law (Abdullatif, 2000).

While Adam Smith's principles of taxation took a central place in the work on tax policy over the past 200 years (Du Preez, 2018) and were referred to in the documents proposing, introducing or assessing tax reforms, they needed to be revisited and enriched over time to keep pace with the changes in business practices (Allen and Bentley, 2005).

Hence, William Newmarch raised the fundamental question of the relationship between equality of tax burden and equality of sacrifice. In other words, would a tax falling equally on all require equal sacrifice from all (Du Preez, 2018)? This is what Mill (1848) argued. He interpreted the equality requirement in Smith's first cannon as an equality of sacrifice, which means that individuals with higher income should pay a higher proportion thereof as tax. This refers to another dimension of the concept of equity, that is vertical equity.

Furthermore, different authors, organizations and committees concerned with tax policy proposed principles of taxation taking the cannons of Adam Smith as a starting point. This is the case of: (i) the American Institute of Certified Public Accountants (AICPA), which published a Tax Policy Concept Statement to propose a set of guiding principles of good tax policy (AICPA, 2017), (ii) the Mirrlees Committee in the UK, who was tasked with reviewing the UK tax system and making proposals to reform it (Mirrlees, 2011), and (iii) the Fiscal Commission Working Group in Scotland, which proposed a set principles to develop a tax system of an independent Scotland (Scottish Government, 2013).

Moreover, the OECD published a report in 1998 addressing the taxation of e-commerce, in which the authors referred to Adam Smith's (1776) maxims and added a number of other principles, one of which is Fairness and Effectiveness (OECD, 1998).

Similarly, as part of its work on the BEPS<sup>2</sup> project, the OECD published in 2015 the final report on BEPS Action 1 addressing the tax challenges of the digital economy in which the same principles as those in 1998 report were adopted and a specific reference to the principle of Equity was made (OECD, 2015).

Efforts of this nature kept going on, and it will be extremely difficult to identify all the instances where experts or committees tried to identify the principles of taxation using the work of Adam Smith as a starting point. Preez and Stiglingh (2018) counted, on a non-exhaustive basis, as many as 19 of such attempts. The vast majority of these attempts, to which we can add the work of Stiglitz (2015) and Scottish Government (2013), refer to the principle of equity or one of the concepts attached thereto (fairness, tax according to ability, etc.).

### **3. PRINCIPLE OF EQUITY**

Equity takes two forms: (i) “horizontal equity”, which entails that persons in similar circumstances should be treated in a similar way and bear similar tax burden, and (ii) “vertical equity”, which is more of a normative concept suggesting that persons that are in better circumstances should pay a higher tax, more than in proportion of their income (OECD, 2015). A simple way to express these two concepts would be: horizontal equity requires that equal people are treated equally, whereas vertical equity requires that unequal people are treated unequally (James and Nobes, 2017).

This simple formula does not mean that the application of the two concepts is straightforward. There are many issues around the meaning of equality and how it should apply. Does it refer to equal income, equal wealth, benefit, utility or expenditures (James and Nobes, 2017)? Furthermore, the meaning of ‘being treated equally’ is not clear. As highlighted by Stiglitz (2015), the key issue relates to identifying what is being assessed; is it the opportunity set available to the taxed persons or the outcome of their action? To explain this, Stiglitz (2015) gives the example of a tax on ice cream whereby chocolate ice cream is taxed at a higher rate than vanilla one (assuming that both have the same cost). If you take two individuals that are in equal circumstances in relation to all relevant factors, except that one likes chocolate and the other likes vanilla, despite being equal, these two individuals will be treated unequally because of the difference in their taste (the person who likes chocolate will be taxed more heavily than the one who likes vanilla). If we look at the opportunities available to them, they are the same, as they could choose either to buy chocolate or vanilla. So, from this perspective, they are treated equally. However, if we look to their decision, taking into account their taste, they are not treated equally (Stiglitz, 2015).

A similar example would be two individuals that are equal in all relevant circumstances (e.g. earning the same income, etc.), but one is chronically sick, the other is not. Assuming that medical expenses are not deductible for income tax purposes (which is the case in most jurisdictions), the question here is: Are they being equally treated when they are required to pay the same amount of tax (Stiglitz, 2015)?

A further difficulty inherent to vertical equity is to determine the basis of taxation i.e. what determines that the concerned persons are better off and need to pay more? And by how much they need to pay more (Stiglitz, 2015)?

To help addressing these issues and better understand this concept of equity, it will be useful to discuss its criteria i.e. the factors that would justify that one individual has to pay more (or less) than another. These criteria are based on different approaches; namely, the benefit

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<sup>2</sup> Base Erosion and Profit Shifting (BEPS) Project is the international community’s response to tackle the issue of tax avoidance (Gueydi and Abdellatif, 2018).

approach, the ability to pay approach and a number of other utility-based approaches. These will be discussed in turn in the following subsections.

### **3.1 Benefit Approach**

The basic idea underlying this approach, which was discussed by many economists and thinkers, including Smith, Locke, Rousseau and Mill, consists in saying that the burden of the tax should be shared in proportion of the benefits gained from the government expenses that are funded by the collected tax (James and Nobes, 2017).

This approach can work in limited cases, such as a tax on the use of bridges or a toll tax on roads, but in most cases, it will be difficult to implement as the magnitude of benefit by each individual cannot be determined. Also, it can result in distortionary effects because the users of a public service for which they pay a charge may be discouraged to use it (Stiglitz, 2015).

The benefit approach is also used to justify taxes that have negative externalities, such as carbon tax, excise taxes on tobacco and other harmful products, etc. Such taxes are generally imposed to compensate the community for the costs incurred as a result of the activities of the taxpayer (Lang and Englisch, 2006).

Furthermore, there are types of public services that target poor/vulnerable population and operate as an income redistribution mechanism. Applying the benefit approach in this case would result in the absurd situation where low-income people pay for these services whereas higher income groups would be exempted (James and Nobes, 2017).

### **3.2 Ability to Pay Approach**

This concept, introduced by Smith's (1776) first cannon, is generally presented as the "benchmark" for tax equity. It means that every taxable person should contribute to the financing of the community in proportion to their ability to pay, expressed in economic capacity (Koritnink and Podlipnik, 2017).

One of the key difficulties related to this concept is to determine the indicator that should be used to measure the ability to pay? Is it income, wealth or expenditures (James and Nobes, 2017)

### **3.3 Income**

Arguably, income is the most obvious choice to measure the ability to pay (James and Nobes, 2017). However, it raises a number of questions such as what income to consider: is it annual income or life-time income (Stiglitz, 2015)? or what should be included in the definition of income? For example, would capital gains, gifts and gambling wins be included in this definition (James and Nobes, 2017)?

Furthermore, the questions related to understanding and implementing vertical equity remain valid in relation to using income as an indicator of the ability to pay. Hence, should the ability to pay be measured by "the ability to earn" that a person has i.e. the opportunity set he had or by the actual income he earned. Stiglitz (2015) gives the example of two individuals (twin brothers) having equal education and abilities. One decides to work only 6 hours a day as a high school teacher and spend the rest of the time on hobbies, whereas the second decides to work more than 70 hours a week as a consultant. The second will obviously have a much higher income (and pay a much higher tax) than the first. The question that Stiglitz (2015) asks here is the following: is it fair to tax the second person more heavily than the first even though they had exactly the same ability to earn/opportunity set?

Stiglitz (2015) recognizes that using the actual income as basis of taxation is easier than using the ability to earn.

Another criticism of using income as a basis of taxation is that it results in double taxation of saving; first when the saved income is realized and second when the income from saving is

earned. Nevertheless, there might be an argument that the income from saving constitutes an extra ability to pay that warrants extra taxation (James and Nobes, 2017).

### **3.4 Expenditures**

For all the criticisms mentioned above, expenditures (or consumption) are often presented as an alternative indicator of the ability to pay/basis of taxation.

First, using expenditures solves the problem of double taxation of saving (James and Nobes, 2017). Consumption is equal to income minus saving ( $C = Y - S$ ), and by taxing consumption, we tax income only when used, which means that unused income (i.e. saving) is not taxed.

Further, consumption as basis of taxation solves the problem of what to include in the definition of income. Used income, regardless of its origin, will be taxed.

Moreover, as argued by Hobbes (1651), consumption is not beneficial to society. In other words, as income is what a person contributes to the community, whereas consumption is what he takes away from it, it would be fairer to tax that person on what he takes away rather than on what he contributes (Stiglitz, 2015).

A key criticism of using consumption as a basis of taxation is the fact that it is much more difficult to build progressivity into a tax on consumption than in a tax on income/profits (James and Nobes, 2017). Hence, if the state wants to increase the tax burden of the rich, it can simply increase the tax rate on the higher income brackets. This is much more difficult to achieve with a consumption tax.

Finally, on the use of life-time income as opposed to annual income as a tax base, Stiglitz (2015) argues that life-time income should be equal to life-time consumption, as saving is only a delayed consumption. Therefore, a tax on life-time income would address all the criticisms raised in relation to (annual) income as a basis of taxation. However, it will be difficult to implement.

### **3.5 Wealth**

The key distinction between wealth and income is that the former is a stock (of property) whereas the latter is a flow. The main question that needs to be addressed as far as taxation is concerned is whether or not wealth confers an additional ability to pay, which justifies additional taxation.

According to James and Nobes (2017), wealth provides advantages other than of pecuniary nature, including status, security, etc. Wealth can also provide real advantages such as capital gains and implicit income. An example of the latter is the value of the benefit received by a homeowner from occupying his home (James and Nobes, 2017). Had he not been the owner, he would have rented it and paid a rent. The amount of the rent represents a good proxy of the value of this advantage. If nothing else, a person with wealth can sell part of his wealth (dis-save) and convert it into cash.

For all these reasons, there are grounds (based on horizontal equity) to confer to wealth an additional ability to pay that warrants an additional taxation.

### **3.6 Equity, ability to pay and income**

Despite all the criticisms, the ability to pay remains the most useful basis for equity, and income remains the most usual indicator of the ability to pay (James and Nobes, 2017). The question of the relationship between the two remains to be addressed, though. For example, does increasing the income of a person by 10%, for instance, mean increasing his ability to pay by the same percentage? Also, until what level tax should be imposed to achieve equity e.g. until all taxpayers are left equal? have made equal sacrifice? etc. James and Nobes (2017) addressed these questions by distinguishing between three options based on utility.

A first option is that tax is imposed until all income earners have made an equal sacrifice in terms utility. With the assumption that the utility curve slopes downwards, each unit of money lost as a result of paying the tax represents a lesser sacrifice of utility as the income increases. This is achieved by a proportional (flat) income tax.

The second option is that income earners pay tax until they make ‘equi-proportional’ sacrifice of utility. With the assumption that marginal utility curve slopes downwards, this means that higher income brings with it higher sacrifice (i.e. larger portion to be paid as tax), which results in a progressive tax system.

The third option is to minimize the aggregate sacrifice of total utility, which is equivalent to maximizing the aggregate utility of the population. In other words, after paying the tax, the marginal utility of all income earners will be the same, which would result in an identical after-tax income for all (James and Nobes, 2017).

#### **4. ZAKAT: KEY FEATURES AND ISSUES**

Zakat is derived from the Arabic verb “Zaka” (زكا، يزكو، زكاء أو زكوا), which means to grow. It has also the meaning of purity and righteousness (Al Ghofeili, 2008). However, the primary meaning seems to be growth, and the meaning of purity and righteousness is a derived one (Al Qaradaoui, 2006).

In Islamic fiqh, classical jurists provided several definitions of Zakat. Taking into account the common features in these definitions as identified by Al Ghofeili (2008)<sup>3</sup>, and referring to the structural elements of a tax, Zakat can be defined as a compulsory levy imposed by Sharia, under certain conditions, on certain elements of wealth and income<sup>4</sup>, at specific rates and for specific uses.

Zakat is due on every Muslim<sup>5</sup> in relation to items of wealth and income that meet certain requirements. These are discussed below.

##### **4.1 Zakat Base: Conditions of Chargeability**

For an item of wealth or income to be subject to Zakat, the following conditions apply.

###### **4.1.1 Full ownership**

The true owner of *Mal* and all things is Allah (SWT), and man can only act as a trustee. However, *Mal* has been attributed to man in several places in Quran, as a way to honor him by Allah (SWT) (Al Qaradaoui, 2006). This is the context in which the meaning of (full) ownership in Sharia should be understood. In simple terms, it means to have a right to appropriate, possess, use and dispose of the property without restriction (Al Qaradaoui, 2006). Accordingly, items of wealth that do not have a specific owner are not subject to Zakat. This is the case, for instance, of assets of public bodies as well as Awqaf when the beneficiaries are not specifically determined (Al Ghofeili, 2008).

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<sup>3</sup> See section 2.

<sup>4</sup> Zakat is charged on “*Mal*”, which covers any type of valuable property. Kahf (1989) defines it as “any material things a person earns or possesses”, including “all kinds of wealth and income”. It is, therefore, broader than the term “wealth” used in the tax context and covers elements of both wealth (or capital) and income.

<sup>5</sup> While Zakat is due on Muslims, nothing prevents the sovereign to charge a tax with similar features as Zakat on non-Muslims (Al Qaradaoui, 2006).

Furthermore, unlike other religious obligations, the conditions of adulthood and sanity do not apply in the case of Zakat. Hence, for the majority of classical jurists, Zakat would apply to the incapacitated (the minor and the insane) if they meet the condition of *Nisab*. Their guardian would be required to pay Zakat for them (Al Qaradaoui, 2006).

In addition, ownership must be “full” such that all of its attributes/rights are fulfilled. Hence, when the asset is not appropriated/possessed by the Zakat payer or the latter is unable to use it or dispose of it, Zakat shall not apply. This is the case, for instance, of assets that are purchased but not yet delivered, assets that are given as a guarantee or a collateral, etc. (Al Qaradaoui, 2006).

The condition of full ownership as envisaged above and some of its applications (e.g. end of benefit allowances which are received only at the end of the employment contract) generally apply in the context of taxes on income. Income tax laws generally require that the taxable income is made available to the taxpayer for the income tax to be charged.

#### **4.1.2 Growth**

According to a majority of jurists, Zakatable items must be predisposed to/intended for growth or productivity, whether this growth is actual or potential. This excludes from the Zakat base items for private use as well as those that are not susceptible, by their nature, to growing or generating profits (lost money, doubtful loans, etc.) (Al Qaradaoui, 2006).

However, the concept of growth (whether actual or potential) is not inclusive of all Zakatable items and may result in arbitrary application of Zakat (Kahf, 1989)<sup>6</sup>. Accordingly, there should be a reconsideration of this condition to ensure a just and consistent application of the same. This reconsideration may be based on a classical fiqh opinion according to which the rationale (*Illa*) of imposing Zakat is richness (i.e. ownership itself) and not growth (Kahf, 1989).

With this approach, Zakat would operate similarly to taxes which are generally charged on items of income or capital that are actually earned or owned, regardless of whether or not they grow.

#### **4.1.3 Nisab**

*Nisab* is the minimum level of wealth/income that is needed to trigger Zakat. There is no dispute amongst jurists that this condition applies to all Zakatable items, except for agricultural products, in respect of which the Hanafi school of fiqh deviates from the main stream opinion and does not require *Nisab* (Al Qaradaoui, 2006).

*Nisab* is determined in Prophet’s (PBUH) Sunna as follows (Al Qaradaoui, 2006):

<b>Item</b>	<b>Nisab</b>
Camels	5
Cows	30
Sheep	40
Other livestock	In value, the equivalent of 5 camels or 40 sheep; and In number, not less than 5
Agricultural products	647 <sup>7</sup> Kg
Gold and Silver	85 grams of 24 Karat gold or 595 grams of silver.

*Nisab* is intended to ensure that Zakat is payable only by those who have a minimum level of wealth. This minimum has been assessed by certain scholars as being equivalent to the needs of a family of three for one year (Al Qaradaoui, 2006).

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<sup>6</sup> Kahf (1989) gives the example of jewelry, which is Zakatable for a number of jurists even though it does not grow.

<sup>7</sup>Al Qaradaoui (2006).

Considering the above, one could argue that *Nisab* is comparable to deductions/allowance under tax laws (Allami, 2015). However, this view is not correct, as *Nisab* is not deductible from the Zakat base. Hence, when *Nisab* is reached, Zakat will apply to the total amount of the Zakat base. *Nisab* operates like a condition to charge Zakat rather than a deduction from its base.

#### **4.1.4 Excess on basic needs**

Zakat will not be chargeable, unless the basic needs of the Zakat payer (and those he sustains) are met. Needs have been defined in a fairly accurate manner by the Hanafi jurists to include “anything that prevents perishing/perdition whether materially or immaterially”. Hence, all basic needs for human life such as food, water, shelter, security, health or for wellbeing in general such as education, work, debt repayment, etc. are all covered in this definition (Al Qaradaoui, 2006).

This condition is different from that on *Nisab*, even though both seem to achieve the same objective (that is to ensure that basic needs are covered before Zakat is due). While *Nisab* is specifically determined by the statements of the Prophet (PBUH) and refers, as per the explanations of certain scholars, to the basic needs for food of a family of 3, the excess on basic needs is deduced from various verses and statements of the Prophet (PBUH) and cover anything the lack of which would cause hardship (Al Qaradaoui, 2006).

This approach in dealing with basic needs to determine Zakat chargeability is perfectly suited to the nature of these needs. There is a minimum level that is common to all human beings at all times (food) and another component that varies over time, places and societies. The condition on *Nisab* would cover the former, whereas the condition on the excess over basic needs would cover the latter. With this approach, Zakat properly addresses the impact of individual circumstances on Zakat liability.

#### **4.1.5 Absence of debt**

This is related to the previous conditions, as full ownership and excess on basic needs would entail that the items of wealth and income that are subject to Zakat are free from any debt or liability.

In simple terms, this condition means that all debts associated with the items included in the Zakat base must be deducted, provided these debts are actual<sup>8</sup> (Al Qaradaoui, 2006).

#### **4.1.6 Elapse of a lunar year**

This condition requires that the item of wealth that is being subject to Zakat has been owned/held by the Zakat payer for 12 consecutive lunar months. This requirement does not apply to agricultural products, mines, treasures and other resources extracted from the ground (Al Qaradaoui, 2006).

## **4.2 Zakat Rates**

Zakat is generally chargeable at the rate of 2.5% on business assets (after deduction of fixed assets<sup>9</sup> and qualifying debts), gold, silver, money and other forms of savings (stocks, etc.).

Zakat on agricultural products is charged at the rate of 10% if the products are irrigated by rain, rivers and other free sources of water and 5% in other cases. Zakat on livestock is determined

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<sup>8</sup> There is a debate amongst jurists as to whether or not this condition applies to all items of wealth and income or only to the non-visible part thereof (i.e. money, gold, silver, etc. as opposed to visible items such as agricultural products, cattle, etc.) (Al Qaradaoui, 2006).

<sup>9</sup> According to the prevailing opinion of jurists.

as per a schedule of rates expressed in terms of number of livestock (which can be of different species than the Zakatable one<sup>10</sup>). Mining resources are subject to a 20% rate.

### **4.3 Administrative aspects of Zakat**

Apart from the due date of Zakat and its collection, Sharia rules left the administrative aspects of Zakat to the sovereign to organize.

As a general principle, Zakat is due on the date the Haul (12 lunar months) elapses, except where the condition of Haul does not apply (see section 4.1.6.). Hence, for agricultural products, for instance, Zakat is due immediately after the crops become available. This is based on Verse 141 of Surat Al Ana'am (Chapter 6 – The Cattle): “...and settle its right [i.e. give Zakat] the day of its harvest”.

As to collection, jurists agreed that the sovereign has the right to collect Zakat. However, in relation to the invisible part of the wealth (e.g. gold, money, trade assets, etc.), Zakat (or part thereof) may also be directly paid to the receivers at the discretion of payer (Al Qaradaoui, 2006).

Other aspects of administering Zakat are left to the sovereign, including the mode, date and place of payment.

Jurisdictions who contemplate to implement Zakat may leverage the capacity already available in their tax authorities to efficiently administer Zakat. This is due to the similarities of the requirements to administer Zakat and taxes. The infrastructure, processes and procedures that are available in tax authorities can easily be adapted to cater for Zakat. Processes such as registration (i.e. Zakat payers' identification), filing, payment and compliance follow up are very similar to those under tax laws and regulations. This approach would be much more efficient than mandating another authority to collect Zakat.

Nevertheless, there is one area where Zakat would require specific procedures and processes that have no equivalent in taxes. That is the task to ensure that Zakat proceeds are used for the specific purposes as prescribed by Sharia rules. This area can be assigned to another authority (such as Zakat institutions) (Al Qaradaoui, 2006).

## **5. ZAKAT AND EQUITY**

As mentioned in section, the concept of equity in the context of tax is measured through different criteria and raises challenges in addressing certain issues such as tax avoidance and evasion and catering for inflation. The way these criteria and issues apply to Zakat will be addressed in the ensuing sub-sections.

### **5.1. Criteria of Equity**

Two key criteria were discussed in section 3., namely, Benefit and Ability to Pay.

#### **5.1.1 Benefit**

Section 3.1 showed the limits of using the benefit approach to justify the imposition of taxes and to assess their fairness.

These limits are even more marked in the case of Zakat because the latter works essentially like a transfer mechanism between the rich (Zakat payers) and the poor, needy, etc. (Zakat receivers). The benefit approach entails that the concerned tax should be borne by those who benefit the most from the public expenditures associated with the tax (James and Nobes, 2017). As the tax and the public expenditures associated therewith are the same in the case of Zakat, the benefit approach would mean that Zakat should be paid by Zakat receivers (the poor, needy, etc.), which is clearly absurd.

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<sup>10</sup> For example, the Zakat due on 5 camels is 1 sheep, etc.

Nevertheless, there may be an argument that Zakat is similar to a wealth tax and, thus, as per Locke's theory of the State being a protector of property, such wealth would benefit from the protection of the State (Vaughn, 1980). Accordingly, there would be a case to tax wealth (through Zakat) in consideration of the protection received. Adam Smith (1776) alluded to this relationship between taxation and the benefit from the protection of the State in his first canon of taxation on equity (see section 2.). However, this argument does not hold in the case of Zakat, as the latter would still remain due even if no protection is provided by the State and even in the absence of a State altogether.

Accordingly, Zakat imposition is not based on benefit, and the latter cannot be used as a criterion to assess the equity of Zakat.

### **5.1.2 Ability to Pay**

Ability to pay refers to the requirement that the contribution to the financing of the community is in proportion to the individual's ability to pay, expressed in economic capacity (Koritnick and Podlipnik, 2017). It is regarded as the most useful basis to assess equity (James and Nobes, 2017).

The first issue that needs to be addressed in relation to the ability to pay is to decide on the indicator/measure that determines it. In section 4.3.1. the indicators of income, expenditures and wealth were discussed and the attributes and shortfalls of each of them were presented. Income was determined to be the most usual (James and Nobes, 2017) and best practical (Schlunk, 2006) measure of ability to pay.

As far as Zakat is concerned, ability to pay as a criterion of imposition does not pose, *prima facie*, any issues. Zakat is meant to achieve social justice by transferring financial resources from those who have excess resources to those who are in need (Kahf, 1989). This is clearly mentioned in Prophet's hadith (PBUH) narrated by Al Bukhari when he sent Moaz (may Allah be pleased with him) to Yemen to preach Islam *"and tell them that Allah [SWT] imposed on them a charity [Zakat] to be taken from their rich and given to their poor"* (Al Qaradaoui, 2006).

Accordingly, it may be argued that the rationale of imposing Zakat is the existence of sufficient resources exceeding the concerned person's needs. The higher these resources, the higher should be the contribution. This is ensured by the proportional nature of Zakat.

Considering the requirements of charging Zakat, and particularly the requirement of the elapse of Haul (12 lunar months), Zakat on individuals (the case of agriculture and livestock apart) is akin to a tax on savings. Therefore, it is safe to say that the ability to pay indicator in the case of Zakat is saving. Let's now examine the issues that were identified with using income, expenditures and wealth as indicators of ability to pay (see section 3.2.) and see to what extent they apply to saving.

#### *5.1.2.1 Income and saving*

The issues raised as to using income as an indicator of the ability to pay are as follows:

##### *i. Definition of Income*

This relates to determining what to include in the definition of income. Hence, would such items as capital gains, gifts and gains from games, etc. be included in this definition (see section 3.2.1.)?

The use of saving as an indicator of the ability to pay, as in the case of Zakat, solves this issue since Zakat is charged on what remains of the income and gains from all sources<sup>11</sup> after consumption.

ii. Opportunity Set or Actual Earning?

A second issue with using income relates to determining whether it is more appropriate to use the ability to earn of an individual or the actual income earned as a basis of determining the ability to pay. In other words, should this ability be assessed on the basis of the opportunity set that were available to the person or the actual income he/she earned as a result of his/her choices.

As mentioned in section 3.2.1., using the opportunity set is difficult to implement (Stiglitz, 2015), that is why the actual income is the best practical (Schlunk, 2006) and most usual indicator of the ability to pay (James and Nobes, 2017).

The same approach is adopted in Zakat. The ability to pay is measured by the actual amount of saving, not by the potential amount that would have been saved taking into account the opportunity set available to the individual. However, the reason for this goes beyond the practical difficulty of using the opportunity set and relates to the fact that Zakat, by design, is triggered only when a person has actually at his/her disposal a certain amount of money that exceeds his/her needs and that remained unused for 1 year (see sections 4.1.4. and 4.1.6.). When this amount is not earned or earned but used for consumption, Zakat is not due. In fact, Sharia rules here recognize that individuals equipped with the same tools (education, skills, experience, etc.) i.e. having, a priori, the same opportunity set, do not necessarily have the same ability to earn. The latter depends on other factors such as personal attributes (will, dynamism, optimism, patience, etc.). Further, Sharia rules take into account the specific circumstances of the individual. When the opportunity set is fully used and the individual's potential to earn is fulfilled, but he/she faces additional expenses that others with similar opportunity set do not face, such that the minimum amount of saving (*Nisab*) is not met, Zakat is not due.

iii. Taking into Account Individual Circumstances

This latter feature of Zakat solves a further issue with using income as an indicator of ability to pay, that is the failure to take into account the particular circumstances of an individual in determining the taxable income. A typical example is when the individual has health issues resulting in additional expenses, which often are not deductible for tax purposes (see section 4.1.4.). Despite the fact that these expenses result in a lower available income, the individual will still be taxed on the same base as someone who earns the same income but does not incur any health expenses.

Another example is having children. If we leave aside the issue of whether or not the decision to have kids should be treated as a consumption decision<sup>12</sup>, the tax relief that is granted in relation to a child is generally much lower than the actual costs of raising the child (Stiglitz, 2015). The difference in taxable income, and tax liability, between an individual having kids and another individual earning the same income but does not have kids is not equal or even close to the difference in available income taking into account the actual expenses of raising the kids.

A further example relates to the volatility of taxpayers' income and its distribution throughout their lifetime. Under a regular (progressive) income tax, two taxpayers having the same lifetime

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<sup>11</sup> Assuming these sources are all sharia compliant.

<sup>12</sup> This is to say that having a child is a similar choice as to buy a house or a car, etc. and, thus, it should not be favored by the tax law (Stiglitz, 2015).

income, but one with a regularly distributed income, whereas the other with a fluctuating one, will end up paying different tax liabilities. The latter would pay a higher tax as than the former a result of the progressive rates (Schlunk, 2006).

Another example (and argument) that supports the case of charging tax on lifetime (rather than annual) income is the fact that the annual income does not take into account the (typical) consumption/expense pattern of taxpayers. In the early years of professional life, an individual faces substantial expenses that generally exceed his/her income (education expenses<sup>13</sup>, buying a house, buying a car, etc.) but that are not (properly) taken into account to determine the tax liability. The outcome is a tax is being due even though the taxpayer's net income is negative, which effectively means that taxpayers borrow to settle their tax liability (Schlunk, 2006).

Zakat, on the other hand, is levied on saving i.e. the remaining income after deducting all expenses. It is charged at a flat rate on the excess resources of the individual that remain unused for 1 year. Accordingly, Zakat solves the issue of income volatility (thanks to its flat rate)<sup>14</sup> as well as the issues of expense pattern and specific circumstances of the taxpayer, since all expenses will be "deductible". As a result, in the early years of the professional life, when the individual is facing substantial expenses, there would be a low or no Zakat liability since there would be no (or little saving). Conversely, towards the end of the professional life, the individual would have higher income (as a result of career progression, investments, etc.) and lower expenses (no children to sustain, no education, housing, etc. expenses). Saving would, thus, be higher and so would be the Zakat liability.

By taking into account more effectively the income volatility, the consumption pattern and the particular circumstances of the individual in determining the tax base and tax liability, it can be safely said that Zakat is more equitable than income tax.

#### Double Taxation of Saving

A final issue raised in relation to using income as an indicator of the ability to pay is the double taxation of saving. As mentioned in section 3.2.1. double taxation arises because saving is taxed, first, when the income is earned and, second, when the return on the saving is earned. While there is an argument that the return on saving represents an additional ability to pay that should trigger additional taxation (James and Nobes, 2017), the issue of double taxation of saving remains one of the serious criticisms of using income as a measure of the ability to pay. As far as Zakat is concerned, there is no double taxation. Zakat is charged only once on the amount of saving that exceeds the *Nisab* and that remains unused for 1 year. So, here again, from an equity perspective, Zakat performs better than taxes, as the indicator of the ability to pay is taxed only once.

#### 5.1.2.2 Expenditures and saving

As highlighted in section 3.2.2., similarly to Zakat, using expenditures as an indicator of the ability to pay solves the issues on the definition of income and the double taxation of saving, but raises the issue of embedding progressivity in the tax.

However, the merits of using expenditures would not be so evident if the lifetime income is used as an indicator of ability to pay instead of the annual income. The reason being that (the present discounted value of) lifetime income is equal to (the present discounted value of) lifetime expenditures (Stiglitz, 2015)<sup>15</sup>. Therefore, there would be no difference in using income or expenditures. This having been said, lifetime income is generally not used because

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<sup>13</sup> These refer to both the taxpayer's own expenses financed by debts, which he/she needs to repay, as well as education expenses of his/her children.

<sup>14</sup> Case of agriculture and livestock apart, regardless of the amount of Zakat base, the rate is always the same (2.5%). Therefore, the distribution of such base over the lifetime of the individual would affect the Zakat liability (if we ignore the effect of inflation).

<sup>15</sup> The assumption here is to ignore inheritances and bequests.

it is difficult to implement (James and Nobes, 2017) and has a strong implication that is generally not validated in reality by tax systems, which is the exemption of interest income (Stiglitz, 2015)<sup>16</sup>.

Accordingly, despite the fact that expenditures solve two of the key issues related to using (annual) income, the latter remained the most useful indicator of the ability to pay (James and Nobes, 2017).

In relation to Zakat, while the merits of embedding progressivity will be discussed in section 5.1.3., it is important to note here that Zakat, by using saving to determine the ability to pay, opts for an indicator that is similar in nature to income in the sense that it is a contribution to society and the economy (as opposed to consumption, expressed in terms of expenditures, which is taken away from it (see section 3.2.2.)). It may be argued, therefore, that this indicator would have the same usefulness and acceptability as income. This is supported by the fact that saving is often subject to (specific) taxation under income and wealth tax laws.

Accordingly, saving would combine the benefits of using expenditures and income as indicators of ability to pay without importing their shortfalls.

#### *5.1.2.3 Wealth and saving*

Wealth can come from two sources: own savings or other sources such as inheritance, gifts, etc. (James and Nobes, 2017).

In section 3.2.3. we discussed whether or not wealth would confer an additional ability to pay that justifies an additional taxation. This issue is particularly relevant where the wealth comes from own savings, which in turn, come from taxed income.

The fact that Zakat uses saving itself as the indicator of ability to pay removes any relevance the question of whether or not saving confers an additional ability to pay may have and, thus, solves the issue.

Furthermore, by taxing wealth itself (represented by saving), Zakat is a more efficient tool to achieve a wealth/income distribution than taxes on wealth, which are generally imposed at lower rates than Zakat or triggered only upon the transfer of wealth. This seems to be confirmed empirically, as Powell (2009) confirmed the existence of a positive relationship between the institutionalization of Zakat<sup>17</sup> and income equality. He found that only 20% of the countries that institutionalized Zakat are in the low equality group (Powell, 2009).

### **5.1.3 Horizontal Equity, Vertical Equity and Progressivity**

While horizontal equity requires taxing equal people equally, vertical equity represents the other face of the coin and requires taxing unequal people unequally (James and Nobes, 2017). Unequal taxation here refers to a higher tax burden as the income increases (progressive taxation) to seek an equality of sacrifice in financing public expenditures.

As far as Zakat is concerned, horizontal equity does not pose any particular issues. Zakat is charged in the same way on individuals that have the same ability to pay, represented by an amount of saving exceeding the *Nisab* and remaining unused for 1 year. Moreover, unlike taxes, Zakat has no exceptions. No exemptions or even statute of limitation period would apply. Even if the concerned person is legally incapacitated (child, insane, etc.), his guardian or the state, as the case may be would step in and pay the Zakat due (Al Qaradaoui, 2006).

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<sup>16</sup> The equality between lifetime income and lifetime expenditures is based on discounting future income (and future consumption) using an interest rate ( $r$ ). So, the income of year 2 ( $Y_2$ ) is equal to the income of year 1 ( $Y_1$ ) multiplied by  $(1+r)$  i.e.  $Y_2 = Y_1 (1+r)$  or  $Y_1 = Y_2 / (1+r)$ . The same applies to consumption ( $C_1$  and  $C_2$ ). No tax is applied on the additional income resulting from the interest earned ( $r*Y_1$ ).

<sup>17</sup> This refers to the collection of Zakat (whether compulsorily or on voluntary basis) through specialized institutions overseen by the State.

In relation to vertical equity, and in contrast with income tax in many countries, Zakat has no progressive rates<sup>18</sup>. It is imposed at a flat rate of 2.5%<sup>19</sup>. The reason is that the purpose of Zakat is only to “purify” one’s self and wealth as stated in Verse 103 of Surat *Al Tawba* (9), in which Allah SWT says: “Take, [O, Muhammad], from their wealth a charity by which you purify them and cause them increase, and invoke [Allah 's blessings] upon them. Indeed, your invocations are reassurance for them. And Allah is Hearing and Knowing”<sup>20</sup>. The purpose of Zakat is not to cause hardship to believers or to deprive them from enjoying their wealth<sup>21</sup>.

Accordingly, Sharia rules on Zakat are not concerned with the equality of sacrifice in this life<sup>22</sup>. They do encourage voluntary charity (almsgiving), but they do not impose on richer individuals to pay higher rates of Zakat. They remain, nonetheless, concerned with the equality of contribution of individuals in the same situation (horizontal equity). Muslim’s money/wealth is protected by Sharia (as his life and honor). Preservation of wealth is one of the global Maqasid (objectives) of Sharia, and according to a number of scholars, the state/sovereign has no right in one’s wealth, except for Zakat<sup>23</sup>. Therefore, according to this view, once Zakat is paid, an individual is not required to pay anything else regardless of how well off is he/she.

Based on the above, and looking at the design features of Zakat, achieving vertical equity does not seem to be an objective. However, this does not necessarily mean that Zakat is not progressive. To determine this, we need to look at the population group on whom the Zakat burden would fall.

To this end, let’s take, first, the example of general consumption taxes such as sales tax or VAT. These taxes are generally regressive (Stiglitz, 2015), this is because the share of consumption in the income (propensity to consume) reduces as the income increases. Therefore, high-income people pay a lesser portion of their income on consumption (and, thus, on tax) than people with low or medium income.

Zakat is comparable to a general consumption tax because its base (viz. saving) is nothing else but the opposite side of consumption i.e. it is what is left from income after consumption ( $S = Y - C$ ). It would, however, operate in the opposite direction as a consumption tax (general sales tax or VAT). Since the propensity to consume ( $c$ ) reduces as the income increases, the propensity to save ( $s$ ) would increase as income increases ( $s = 1 - c$ ). Accordingly, the higher the income earned, the higher the saving and the higher the Zakat due.

Now let’s consider an income tax with a progressive schedule of rates (i.e. tax rates increase as the income brackets go higher). This tax will charge higher rates on higher income brackets, which would result in a reduction in income disparity due to the resulting transfer from high-income to low and medium-income earners (James and Nobes, 2017). However, higher rates on high-income earners would encourage the latter to work less and spend more time on

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<sup>18</sup> There is an argument that the fact that the amount below the Nisab is not subject to Zakat amounts to a certain form of progressivity. It is as if Zakat is charged at the rate of 0% up to Nisab and at 2.5% on amounts above the same (Powell, 2009). This is however not supported by the way Zakat is computed, as the full amount of saving is taxed when the Nisab is reached and no deduction is operated in relation to Nisab (see section 4.1.3.).

<sup>19</sup> Leaving aside the particular cases (see section 4.2.).

<sup>20</sup> Translation of Quran. Source: <https://englishquran.app/surah>.

<sup>21</sup> Allah SWT says in Verse 32, Surat *Al Aaraf* (7): “Say, “Who has forbidden the adornment of Allah which He has produced for His servants and the good [lawful] things of provision?” Say, “They are for those who believe during the worldly life [but] exclusively for them on the Day of Resurrection.” Thus, do We detail the verses for a people who know”.

<sup>22</sup> Progressivity and equality of sacrifice is recognized in the hereafter, as demonstrated by the Prophet’s (PBUH) Hadith that a charity of one dirham outperformed that of 100,000 dirhams (narrated by Al Nisaii (Hadith No. 2527)).

<sup>23</sup> There is a different view whereby the sovereign may impose additional charges on people (taxes) if there is a need and Zakat is not sufficient, provided certain requirements are met (Al Qaradaoui, 2006).

leisure<sup>24</sup>, which would increase the return on labour of high-income earners, which in turn would increase prices for consumers (James and Nobes, 2017). As a result, the burden that was intended to fall on high-income earners is transferred to consumers who may be medium or even low-income earners depending on the market of the consumed goods.

Therefore, despite being charged at a flat rate, Zakat can generally be more progressive than an income tax that is charged at progressive rates.

In relation to agriculture (excluding livestock<sup>25</sup>), Zakat is generally charged at a flat rate on the output. It is, therefore, comparable to a sales tax on a specific commodity (or an excise tax). The progressivity of such tax will depend on the demand elasticity of the concerned commodity. The more elastic the demand, the higher the portion of the tax to be borne by producers and vice versa (James and Nobes, 2017). In the extreme case of a perfectly elastic demand, the tax will be fully borne by producers, because the tiniest change in the price will reduce the demand to nil (the demand curve is a horizontal line). Conversely, where the demand is perfectly inelastic, the tax will be fully borne by consumers because regardless of how high or low is the price, the demand remains the same (the demand curve is a vertical line).

Therefore, the progressivity of Zakat will depend on the demand elasticity of the concerned produce. If it is mainly consumed by high-income earners, Zakat will be progressive, whereas if it is mainly consumed by low or medium-income earners, Zakat will be regressive.

## **5.2. Tax Avoidance, Tax Evasion and Zakat**

Tax avoidance refers to arranging one's tax affairs in order to reduce the tax liability within the boundaries of the law, whereas tax evasion consists in using illegal means to achieve the same result (James and Nobes, 2017). On the moral front, the immoral character of tax evasion is obvious and generally not disputed, but that of tax avoidance has been subject to controversy and debate (Christians, 2014), at least until the BEPS project was initiated as a response to the Global Financial Crisis with the aim to end tax avoidance opportunities caused by the inconsistency between domestic and international tax rules (Gueydi and Abdullatif, 2018). The immoral character of the ability to avoid tax, particularly by big multinationals, was one of the key drivers of the BEPS project<sup>26</sup>.

Considering tax avoidance and tax evasion in the context of equity is relevant because they both result in transferring the burden of the tax from those who are able (and willing) to avoid/evade tax to those who are not (i.e. compliant taxpayers). Conversely, where a tax is perceived to be unfair/inequitable, the legitimacy of the tax and its acceptability will be questioned, which will justify and encourage the avoidance/evasion of the tax.

The main causes of tax avoidance and evasion are high tax rates, imprecise laws, insufficient penalties and the inequity of the tax system (James and Nobes, 2017).

As far as Zakat is concerned, avoidance and evasion are expected to be less of an issue than in the case of tax for the following reasons:

First, and most importantly, Zakat is decreed by divine revelation. Its appropriateness and fairness as well as its acceptability would not be questioned by believers. This explains why Muslims are generally keen to correctly determine Zakat and pay it (Rejeb, 2020). Accordingly, the issue of equity in relation to Zakat, if any, would only be raised in relation to the procedures, processes and systems of collection, which are not governed by Sharia and left to the State/sovereign to organize.

Second, the rate of Zakat is low. It is a flat rate of only 2.5% (agriculture aside). In addition, Zakat rules do not seek equality of sacrifice to achieve vertical equity (see section 5.1.3.).

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<sup>24</sup> As a result of the substitution effect of tax.

<sup>25</sup> Zakat on livestock is charged at specific rates depending on the number of cattle (see section 4.2.).

<sup>26</sup> See <https://www.oecd.org/about/impact/combatinginternationaltaxavoidance.htm>

Accordingly, regardless of how high is the wealth of an individual, he/she is only required to pay 2.5% of the savings that remain unused for 1 year. Therefore, the incentive to avoid/evade Zakat is low.

Third, in relation to penalties, while generally Sharia rules on Zakat do not contain detailed provisions on penalties similar those that can be found in tax laws to address avoidance/evasion (financial sanction, prison sentences, etc.)<sup>27</sup>, they do contain a very effective deterrence tool, which triggers a built-in self-compliance mechanism. That is to make acceptance of (and, thus, compliance with) Zakat a matter of faith. Zakat is not just a religious obligation; it is one of the five pillars of Islam. Hence, a Muslim is not a Muslim if he/she questions the legitimacy or the obligation to pay Zakat. This explains why compliance with Zakat is generally very high, even if a significant part of its payment is made directly to beneficiaries and is not captured by official channels (Powell, 2009).

In relation to imprecise rules as a reason of avoidance/evasion, it may be an issue in the case of Zakat. In fact, while the key features are clearly spelled out in Sharia and, more specifically, in the noble Sunna and scholars' *Ijtihad*, the variety of opinions on the *Zakatability*<sup>28</sup> of certain items of wealth, in the past and more so now with the continuous developments and innovations in the financial and technology fields, may make Zakat rules imprecise and unclear, even for instructed Muslims.

In addition, the requirement of clarity and precision extends to the rules governing the administration and collection of Zakat, as explained by Smith (1776) in his second canon of taxation on certainty. The lack of such clarity would impact compliance with the ("official") Zakat system, but would not significantly impact the payment of Zakat itself as individuals would still pay it off such a system.

### **5.3. Zakat and Inflation**

The impact of inflation on tax, even though it is an economic issue in nature, is generally addressed under the principle of equity. It looks at the impact of inflation on income brackets, value of assets, returns, etc. This is particularly relevant in the case of income tax, for instances, which generally attempts to achieve vertical equity by charging progressive rates i.e. higher rates on higher income brackets and, vice-versa, lower rates on lower income brackets (including an exemption for the first income bracket to ensure that the amount of income needed for basic needs is not taxed).

In times of inflation, the real value of the amounts of income brackets reduces. Hence, unless their amounts are adjusted, higher tax rates would apply to taxpayers without a corresponding increase in their ability to pay, and higher tax revenues would be collected. Besides the issue of equity, this raises an issue of legitimacy, since the additional tax charged as a result of inflation was not authorized by the legislature (Stiglitz, 2015). The same applies to tax on capital gains or on return from investments. Tax is generally charged on the nominal amounts of the gain or return, but, in real terms, such gain or return is lower or may even not exist. That is why some jurisdictions adjust periodically the income brackets to take into account inflation. In relation to Zakat, there are a number of factors embedded in the design of Zakat itself that would reduce the effect of inflation. Most notably, the trigger of Zakat i.e. the *Nisab* is not determined in monetary terms. Hence, in agriculture, the *Nisab* is either a weight of produce or a number (in the case of cattle). In all other cases, it is determined by a weight of gold or silver. In both cases, the *Nisab* is largely immune from the effects of inflation. This is an additional factor showing that Zakat outperforms income tax in terms of equity.

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<sup>27</sup> There is a Hadith of the Prophet PBUH which allows the sovereign to take Zakat and half of the *Mal* from Zakat evaders (Al Qaradaoui, 2006).

<sup>28</sup> As an equivalent to "taxability" i.e. being subject to Zakat.

Another factor is the base of Zakat. By being charged on saving, Zakat fully takes into account the effect of inflation. Where prices increase, individuals' expenses will increase and their saving will reduce and so will their Zakat liability.

### **Conclusion**

The paper went through the various criteria, elements and issues associated with the concept of tax equity and applied them to Zakat.

Overall, it appears that Zakat and tax share a similar understanding of the concept of equity, as Zakat: (i) accepts the ability to pay as a criterion of equity, (ii) is based on horizontal equity and (iii) embeds a mechanism of self-compliance that tackles avoidance and evasion.

Moreover, it also appears that Zakat is better equipped than tax to address the issues around implementing equity such as catering for inflation or determining and measuring the ability to pay.

More specifically, the table below summarizes the assessment of the various measures of the ability to pay addressed in the paper. The assessment will be based on the issues raised by the use of income<sup>29</sup> as a measure of the ability to pay, namely: (i) the definition of the measure, (ii) whether or not the measure causes double taxation of saving, (iii) how effective is the measure as an indicator of fairness, this specifically refers to the ability of the measure to take into account the income volatility, expense pattern and the specific circumstances of the taxed person, (iv) the acceptability of the measure, (v) its economic incidence (progressivity) and (vi) the effect of inflation.

The plus (+) sign indicates that the measure performs reasonably well in addressing the issue, whereas the minus (–) sign indicates the opposite.

### **Table 1.**

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<sup>29</sup> Income being the best practical measure of the ability to pay (Schlunk, 2006).

Issue  Measure of Ability to Pay	Definition	Double Taxation of Saving	Effectiveness as an indicator of fairness	Acceptability	Progressivity (economic incidence)	Effect of Inflation <sup>30</sup>
<b>Income</b>	–	–	–	+	–	–
<b>Wealth<sup>31</sup></b>	–	–	–	+	–	–
<b>Expenditures</b>	+	+	+	–	–	–
<b>Saving (Zakat)</b>	+	+	+	+	+	+

Source: The author.

The table shows that Zakat, by using saving as a measure of the ability to pay, outperforms taxes in terms of implementing equity.

<sup>30</sup> Taxation based on income, wealth and expenditures does not take into account the effect of inflation. Without an adjustment, the increase of the amounts of income, wealth and expenditures as a result of inflation triggers additional taxation without a corresponding increase in the ability to pay.

<sup>31</sup> Wealth as an indicator of ability to pay would share the same characteristics as income, because: (a) the definition of taxable wealth, like the definition of taxable income, can be a challenge, particularly if both income tax and wealth tax apply, (b) Double taxation of saving is an issue particularly if wealth comes from own saving, (c) taxing wealth does not generally take into account the specific circumstances of the taxed person, (d) wealth as an indicator of ability to pay is generally acceptable, as shown by the prevalence of wealth taxes in many countries, (e) taxing wealth would generally involve taxing at least one factor of production (capital), which results in higher return on this factor, which in turn results in higher prices. The final impact would be felt by consumers, which would reduce the progressivity of the tax, and (f) in the absence of adjustment, tax is levied on the nominal value of wealth. In times of inflation, the tax base (and the tax) will increase without a corresponding increase in the ability to pay.

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