Ending Exploitative Taxation: A Zakat-Based System for Justice, Economic Growth, & Welfare for All

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Executive Summary

The fiscal architecture of the Islamic Republic of Pakistan stands at a precarious juncture, characterized by a systemic inability to mobilize adequate resources for development while simultaneously imposing an onerous and inequitable burden on its most vulnerable citizens. The prevailing tax regime is a legacy of colonial extraction, compounded by decades of ad-hoc policy adjustments that have prioritized short-term revenue targets over structural integrity. This system relies heavily on regressive indirect levies, which disproportionately affect lower-income households, and operates through an administrative apparatus that creates prohibitive compliance costs for the formal sector while failing to capture the vast expanse of the shadow economy.

The consequences of this dysfunction are manifest: chronic fiscal deficits, a persistent reliance on domestic and external borrowing, degraded public infrastructure, and a social contract that has been effectively severed. The state's inability to tax the wealthy—particularly in sectors such as agriculture, real estate, and retail—has eroded its moral authority and fueled a massive trust deficit. This deficit is quantified by the existence of a parallel, informal welfare system funded by private philanthropy that dwarfs state-led social protection initiatives.

This comprehensive research report, authored by Abdul Hadi, posits a radical yet culturally grounded restructuring of Pakistan's public finance system. It advocates for the integration of **Zakat**—a mandatory, wealth-based Islamic fiscal instrument—as a foundational pillar of the national revenue and welfare framework. Unlike conventional taxation, which is often viewed as a coercive penalty on productivity, Zakat is a divinely mandated obligation (*Fard*) rooted in the spiritual and moral consciousness of the majority of the population.

Drawing upon an exhaustive review of fiscal data from FY 2023-24 and FY 2024-25, alongside empirical surveys conducted in 2024, this analysis demonstrates that the economic potential of Zakat in Pakistan is vastly underestimated. While the state-administered Zakat fund collects a negligible PKR 8-10 billion annually, private Zakat contributions are estimated to exceed **PKR 619 billion**, surpassing the federal budget of the Benazir Income Support Programme (BISP). Furthermore, the economy-wide potential of Zakat, if fully institutionalized through a trusted framework, is estimated at approximately **PKR 3 trillion**.

This report does not argue for the immediate abolition of all secular taxes but proposes a phased transition toward a Zakat-centric model that prioritizes asset-based taxation over income and consumption taxes. By leveraging the principles of Zakat—specifically its focus on accumulated surplus wealth, its fixed and certain rate structure, and its earmarked distribution for poverty alleviation—Pakistan can construct a fiscal system that is inherently progressive,

macroeconomically stabilizing, and socially legitimate. The proposed blueprint involves a public-private partnership model inspired by successful implementations in Malaysia and Indonesia, utilizing tax rebates and digital transparency to bridge the trust gap and formalize the economy.

1. The Anatomy of Fiscal Failure: Inequity and Inefficiency in the Status Quo

To understand the imperative for a Zakat-based system, one must first dissect the structural pathologies of the current tax regime. Pakistan's fiscal system is not merely underperforming; it is actively retarding economic growth and exacerbating social inequality.

1.1 The Regressive Nature of Indirect Taxation

The cornerstone of a just fiscal system is vertical equity—the principle that tax burdens should correlate with the ability to pay. Pakistan's tax structure systematically violates this principle by relying overwhelmingly on indirect taxes. In FY 2024-25, the Federal Board of Revenue (FBR) continued to derive the majority of its revenue from indirect sources such as the General Sales Tax (GST), Federal Excise Duty (FED), and customs duties. While the government claims an increasing share of "direct taxes," a closer examination reveals that a significant portion of this category comprises Withholding Taxes (WHT), which function effectively as indirect consumption taxes.

The Burden on the Poor: Empirical evidence provides a damning indictment of this reliance on indirect taxation. A seminal study by Khan (2015), which remains the benchmark for incidence analysis in Pakistan, utilized Household Integrated Economic Survey (HIES) data to demonstrate that the poorest decile of the population bears the heaviest tax burden relative to their income. The data indicates that the poorest 10% of households pay approximately **9.3%** of their total income in indirect taxes. In stark contrast, the richest 10% of households contribute only **5.9%** of their income to these levies.

This disparity arises from the consumption patterns of different income groups. Low-income households spend a vast majority of their earnings on food, utilities, and basic transport—all of which are subject to indirect levies either directly or through the pass-through effects of fuel taxes. Wealthier households, conversely, save a larger portion of their income or spend it on services and luxury assets that are often undertaxed or shielded by exemptions.

Inflationary Impact: The regressive nature of the tax system is exacerbated by inflation. In FY 2023-24, as inflation hovered around historic highs, the government's reliance on increasing GST rates and petroleum levies acted as a catalyst for price hikes, further eroding the purchasing power of the poor. This creates a cycle of impoverishment where the state extracts resources from those living at the subsistence level to fund its operations, including the servicing of debt accumulated to finance the lifestyle of the elite.

1.2 The Administrative Quagmire: High Compliance Costs

A tax system must not only be fair but also efficient. It should minimize the "deadweight loss"—the economic efficiency lost due to the tax itself—and the administrative cost of compliance. Pakistan's tax administration fails spectacularly on both counts.

The "577 Hours" Reality: According to the World Bank's *Doing Business 2020* report, businesses in Pakistan spend an average of **577 hours per year** complying with tax regulations. This figure is staggering when compared to the global average of 108 hours and significantly higher than regional peers. This time is spent navigating a labyrinth of filing requirements, responding to notices, and managing audits.

The sheer complexity of the tax code, embodied in the 634-page Income Tax Ordinance of 2001 and the endless stream of SROs, necessitates that even small businesses hire specialized tax consultants. This imposes a "compliance tax" on the formal sector, discouraging small and medium enterprises (SMEs) from entering the tax net. The World Bank ranked Pakistan **161st out of 190 economies** on the "paying taxes" indicator, highlighting the procedural toxicity of the environment.

Fragmentation and Harassment: The post-18th Amendment fiscal landscape has introduced new layers of complexity. Businesses now face a fragmented system where they must file returns with the FBR for federal taxes and with provincial revenue authorities (such as PRA, SRB) for sales tax on services. This fragmentation leads to double taxation disputes and jurisdictional conflicts. Furthermore, the FBR's enforcement strategy often relies on harassment and arbitrary bank attachment, creating a climate of fear that drives capital flight and incentivizes the use of cash.

1.3 Structural Flaws: The Narrow Base and Elite Capture

The persistent stagnation of Pakistan's tax-to-GDP ratio—hovering between 8.5% and 10.3% over the last decade—is not a result of low economic capacity but of deliberate policy choices that favor powerful interest groups.

The Agricultural Exemption: The most glaring anomaly is the taxation of agriculture. Despite contributing approximately **24% to the GDP** and employing nearly 37% of the labor force, the agriculture sector's contribution to tax revenue is less than **1%**. Agricultural income tax is a provincial subject, and provincial assemblies, historically dominated by landed elites, have maintained negligible rates and weak collection mechanisms. In FY 2023-24, the total collection from provincial agricultural income taxes was a pittance compared to the sector's output. This creates massive horizontal inequity: a salaried individual earning PKR 100,000 a month sees a significant chunk deducted at source, while a landowner earning millions from harvest pays virtually nothing.

Real Estate Speculation: Similarly, the real estate sector functions as a tax shelter. The difference between the Deputy Commissioner (DC) rates used for taxation and the actual market value of properties allows vast amounts of undocumented wealth to be parked in unproductive land. This speculative investment yields high returns with minimal tax liability, diverting capital away from industrial and productive sectors that generate employment.

The Cost of Exemptions: The tax code is riddled with exemptions and concessions granted to specific industries, often through opaque SROs. The "Tax Expenditure Report 2024" released by the FBR estimates the revenue foregone due to these exemptions at nearly **PKR 3.9 trillion**, which is roughly **3.6% of GDP**. These expenditures include reduced rates for specific sectors, zero-rating regimes, and tax credits that often benefit large conglomerates. While some exemptions are policy-driven, many are the result of lobbying, creating distortions that penalize non-privileged competitors.

1.4 The Shadow Economy: A Rational Response

The combination of high tax rates, high compliance costs, and low morale has driven a massive portion of the economy underground. Estimates from the World Bank and other independent researchers suggest that Pakistan's **shadow economy is equivalent to approximately 40% of the official GDP**.

This informal sector operates entirely in cash, avoiding all direct taxes and labor regulations. However, the decision to remain informal is often a rational economic choice. When the cost of formalization (taxes + bribes + compliance time) exceeds the benefits (access to credit + legal protection), businesses choose informality. The current punitive tax regime essentially subsidizes the shadow economy, forcing the FBR to squeeze an ever-shrinking pool of compliant taxpayers, which in turn encourages more businesses to exit the formal sector.

2. The Credibility Crisis and the Philanthropic Parallel

The failure of the state to collect taxes is mirrored by its failure to manage welfare. This dual failure has led to the emergence of a parallel fiscal system run by the citizens themselves.

2.1 The Trust Deficit

Tax compliance is largely a function of the social contract: citizens pay taxes in exchange for public goods and services. In Pakistan, this contract is broken. Citizens see their taxes funding the perks of the elite, the losses of State-Owned Enterprises (SOEs), and debt servicing, with little returned in the form of education, health, or security.

This mistrust extends to the state-administered Zakat system. Introduced in 1980 under the Zakat and Ushr Ordinance, the state system was intended to centralize Islamic welfare. However, it has been plagued by allegations of political patronage, corruption in Local Zakat Committees, and bureaucratic inefficiency. Consequently, less than **2%** of Zakat payers choose to route their contributions through the state. The "deduction at source" mechanism on bank accounts is widely viewed as a nuisance, leading to massive withdrawals of deposits just before the deduction date (1st of Ramadan) to avoid what is perceived as a "state penalty" rather than a religious duty.

2.2 The Scale of Private Generosity

While the state struggles to collect revenue, the Pakistani public is incredibly generous. A groundbreaking 2024 survey conducted by the International Centre for Tax and Development (ICTD) and the Lahore University of Management Sciences (LUMS) sheds light on the magnitude of this private giving.

- **Private Contributions:** The survey estimates that Pakistanis privately contribute over **PKR 619 billion** (approx. GBP 1.7 billion) annually in Zakat alone. This figure does not include other forms of charity like *Sadaqah* or *Khairat*.
- **Comparison with State Welfare:** To put this in perspective, the total federal budget allocation for the Benazir Income Support Programme (BISP), the state's flagship social safety net, was approximately **PKR 598 billion** for FY 2024-25. This means that **private Zakat contributions exceed the state's largest welfare budget.**
- **Total Potential:** Research by the Institute of Policy Studies (2023) suggests that if Zakat were fully collected on all zakatable assets—including gold, silver, livestock, agricultural produce, and trade inventory—the total potential collection could reach nearly **PKR 3 trillion**.

This data reveals a critical insight: Pakistan does not have a resource problem; it has an intermediation problem. The resources to alleviate poverty and fund development exist within the economy, but they are bypassing the state due to a lack of trust.

2.3 The "Sectarian" Challenge in State Administration

One of the complexities of state-managed Zakat is the divergence in Islamic jurisprudence (*Fiqh*). Different schools of thought (Hanafi, Jafari, etc.) have different rulings on what assets are zakatable, the applicable rates, and the conditions for disbursement. The uniform application of the Zakat and Ushr Ordinance 1980 caused significant friction, particularly with the Shia community, leading to exemptions and a general sense that the state was encroaching on religious freedom.

The failure to accommodate these nuances has contributed to the delegitimization of the state system. A reformed system must be pluralistic, allowing citizens to discharge their Zakat according to their own jurisprudential understanding while maintaining a regulatory framework that ensures transparency and prevents abuse.

3. Zakat: A Structural Alternative for Fiscal Justice

In the context of a broken tax system and a vibrant private philanthropy sector, Zakat presents itself not just as a religious duty but as a superior fiscal instrument. Its design principles offer solutions to many of the structural flaws of the conventional tax regime.

3.1 Theoretical Foundations: Wealth vs. Income

The fundamental difference between Zakat and modern taxation lies in the "Basis of Charge."

- **Conventional Tax:** Primarily targets **Flows** (Income, Sales, Transactions). It penalizes the generation of income and the activity of consumption.
- **Zakat:** Primarily targets **Stocks** (Accumulated Net Wealth). It penalizes the hoarding of idle capital.

The Base: Zakat is levied on *Zakatable Assets* that exceed the *Nisab* (threshold). These assets include:

1. **Gold and Silver:** The traditional store of value.
2. **Cash and Liquid Investments:** Bank deposits, bonds, shares.
3. **Merchandise/Inventory:** Stock-in-trade for businesses.
4. **Livestock:** Specific categories of animals.
5. **Agricultural Produce:** Taxed as *Ushr* (10% or 5% of output).

Crucially, personal use assets (primary residence, personal vehicle, tools of the trade) are exempt. This focus on "surplus wealth" makes Zakat inherently progressive. It automatically exempts the poor and the struggling middle class who may have income but lack accumulated savings. In contrast, indirect taxes hit the poor on their very first rupee of spending.

3.2 Economic Mechanics: The Anti-Hoarding Mechanism

From a macroeconomic perspective, Zakat acts as a penalty on idle resources. If an individual holds PKR 10 million in gold or cash and does not invest it, Zakat will erode this wealth at a rate of 2.5% per year. To preserve the value of their capital, the holder is economically compelled to

invest it in productive ventures that yield a return greater than 2.5%.
This mechanism has profound implications:

- **Mobilization of Savings:** It forces capital out of safes and into the market, increasing the supply of loanable funds or direct equity investment.
- **Velocity of Money:** By penalizing hoarding, Zakat increases the velocity of money circulation (V in the equation of exchange MV=PY), which stimulates economic activity without the need for inflationary money printing.
- **Investment vs. Speculation:** While modern capital gains taxes often fail to curb real estate speculation, a Zakat regime that includes speculative land holdings as "trading stock" would impose a carrying cost on land hoarders, potentially cooling the overheated real estate market and directing capital toward industry.

3.3 Automatic Stabilization

Keynesian economics advocates for counter-cyclical fiscal policy—spending more during recessions to boost demand. Zakat achieves this organically as an "Automatic Stabilizer".

- **Mechanism:** During an economic downturn, incomes may fall, but wealth stocks (the Zakat base) remain relatively stable in the short term. Zakat collections, therefore, do not collapse as sharply as income tax revenues. Simultaneously, the number of eligible recipients (*Mustahiq*) increases due to unemployment.
- **Aggregate Demand:** Zakat transfers purchasing power from those with a low Marginal Propensity to Consume (the wealthy) to those with a high Marginal Propensity to Consume (the poor). The poor spend almost 100% of this transfer on basic necessities. This immediate injection of consumption demand supports local businesses and prevents a collapse in aggregate demand during recessions.

3.4 Certainty and Simplicity

Compared to the "577 hours" of tax compliance, Zakat is a model of simplicity.

- **Fixed Rate:** The standard rate is **2.5%**. There are no complex brackets, no marginal rates, and no arbitrary SROs changing the rate overnight.
- **Defined Threshold:** The *Nisab* (approx. 87g gold or 612g silver) provides a clear cut-off. If you are below it, you pay nothing.
- **Self-Assessment:** The calculation is straightforward: (Assets - Liabilities) x 2.5%. This simplicity reduces the need for expensive intermediaries and reduces the scope for corruption by tax collectors.

Table 1: Zakat vs. Conventional Taxation

Feature	Zakat System	Conventional Pakistani Tax System
Primary Basis	Net Accumulated Wealth (Stock)	Income (Flow) & Consumption
Incidence	Progressive (Exempts those below Nisab)	Regressive (Heavy indirect tax burden on poor)
Rate	Fixed 2.5% (Certainty)	Variable, Multi-layered (Uncertainty)

Feature	Zakat System	Conventional Pakistani Tax System
Compliance Cost	Minimal (Simple Math)	High (577 Hours/Year)
Goal	Circulation of Wealth / Purification	Revenue Generation for State / Debt Service
Utilization	Earmarked for Welfare (8 Asnaf)	General Budget (Fungible)

4. International Models: Lessons in Integration

Pakistan is not the only Muslim-majority country grappling with these issues. Malaysia and Indonesia provide successful models of how Zakat can be integrated into a modern fiscal state.

4.1 Malaysia: The Tax Rebate Mechanism

Malaysia has effectively harmonized its civil tax code with Zakat obligations to encourage formal compliance. Under **Section 6A(3) of the Income Tax Act 1967**, individual Muslims are eligible for a **tax rebate** on Zakat paid to state authorities.

- **How it Works:** A tax rebate is a direct deduction from the *tax payable*, not just the *taxable income*.
    - *Scenario:* A taxpayer has a tax liability of RM 5,000. They pay RM 2,000 in Zakat to the state collection center. Their net tax liability to the Inland Revenue Board becomes RM 3,000. If they pay RM 5,000 in Zakat, their tax liability becomes zero.
- **The Impact:** This eliminates double taxation. It incentivizes Muslims to pay Zakat through official channels because it directly reduces their secular tax burden. This brings the money into the documented system, allowing the state to track wealth while respecting religious obligations.
- **Relevance for Pakistan:** Currently, Pakistan treats Zakat as a "deductible allowance" (reducing taxable income), which offers a much smaller benefit than a rebate. Adopting the Malaysian rebate model would be a powerful incentive for documentation.

4.2 Indonesia: The Public-Private Partnership

Indonesia recognizes that the state cannot monopolyze Zakat. Law No. 23 of 2011 established a hybrid system.

- **BAZNAS:** The National Board of Zakat (State body) acts as a regulator and coordinator.
- **LAZ:** Zakat Management Institutions (Private, civil society bodies) are licensed by the state to collect and distribute Zakat.
- **Integration:** The LAZ must report their collections and disbursements to BAZNAS. This creates a unified national database of welfare without the state physically seizing the funds.
- **Relevance for Pakistan:** Given the trust deficit in Pakistan, the FBR cannot simply "take over" Zakat. The Indonesian model of licensing trusted private entities (like Edhi, Akhuwat) and integrating their data is the only viable path to formalization.

5. A Blueprint for Reform: The Zakat-Based Fiscal

Transition

Based on the analysis of Pakistan's structural failures and the potential of Zakat, the following roadmap is proposed. This plan does not advocate for the immediate dismantling of the tax system but for a strategic pivot that places Zakat at the center of social welfare and wealth documentation.

5.1 The "National Welfare Foundation" (NWF) Proposal

To overcome the trust deficit, Pakistan should establish a **National Welfare Foundation (NWF)**, independent of the Ministry of Finance and the FBR.

- **Structure:** A federally chartered but autonomous body governed by a board comprising reputable scholars, private sector leaders, and civil society representatives.
- **Mandate:** To regulate, standardize, and facilitate Zakat collection and disbursement, acting as a clearinghouse for data rather than a centralized collector.

5.2 Phase 1: Incentivization and Documentation (Years 1-2)

Action 1: Convert Deductions to Rebates Amend the Income Tax Ordinance 2001 to transform Zakat paid to approved institutions (NWF-certified) from a deductible allowance to a **full tax credit** (Rebate).

- *Mechanism:* If a taxpayer pays PKR 100,000 in Zakat to a certified NGO (e.g., Shaukat Khanum), they receive a PKR 100,000 credit against their income tax liability.
- *Benefit:* This encourages taxpayers to declare their wealth and Zakat payments, effectively documenting the shadow economy without coercion.

Action 2: Digital Welfare Portal Launch a blockchain-based portal where all certified Zakat institutions must log receipts and disbursements.

- *Transparency:* Donors can track their Zakat. The state gains visibility into the "Social Safety Net" provided by the private sector, allowing BISP to avoid duplication and target the unserved.

5.3 Phase 2: Harmonization and Ushr (Years 3-5)

Action 3: Revitalize Agricultural Taxation via Ushr Provincial governments should replace the failed Agricultural Income Tax with a standardized **Ushr** regime.

- *Rationale:* Farmers are culturally and religiously predisposed to paying Ushr (tithe on harvest).
- *Localization:* Ushr collection should be decentralized to the district level. Funds collected in a district must be spent on the poor of *that* district. This visible local benefit will skyrocket compliance compared to sending money to a provincial capital.

Action 4: Productive Zakat Protocols The NWF must issue guidelines shifting Zakat usage from consumption (cash handouts) to production.

- *Microfinance:* Use Zakat funds to provide interest-free loans or grants for small businesses, livestock, and tools.
- *Debt Relief:* Utilize the *Gharimun* (debtors) category of Zakat to pay off high-interest debts of the poor, freeing them from debt bondage.

5.4 Phase 3: Structural Shift (Years 5+)

Action 5: Re-aligning Secular Taxes As Zakat documentation broadens the base, the state can afford to reduce regressive indirect taxes (GST) and high corporate tax rates.

- *Wealth Tax:* The state should reintroduce a secular Wealth Tax on assets *not* covered by Zakat (e.g., luxury real estate in excess of needs, high-end vehicles) to mirror the progressive logic of Zakat in the secular sphere.

Table 2: Comparative Fiscal Potential (Estimates)

Revenue Head	Current Collection (Approx.)	Potential / Target	Strategy for Gap
FBR Tax Revenue	PKR 9.3 Trillion	PKR 13 Trillion	Broadening base, reducing exemptions
State Zakat	PKR 10 Billion	--	Shift to Regulatory Role
Private Zakat	PKR 619 Billion	PKR 3 Trillion	Formalize via Tax Rebates
Agri. Income Tax	< PKR 3 Billion	PKR 800 Billion	Convert to Localized Ushr
Tax Exemptions	--	Save PKR 3.9 Trillion	Phase out non-essential SROs

(Source: FBR Data FY24, IPS Estimates 2023, ICTD Survey 2024)

6. Conclusion

The current fiscal trajectory of Pakistan is unsustainable. It is a system that penalizes the honest, subsidizes the elite, and crushes the poor. The "577 hours" of compliance time and the 9.3% indirect tax burden on the poor are not just statistics; they are indictments of a broken social contract.

Zakat offers a path to redemption. It is not an archaic relic but a sophisticated economic instrument capable of stabilizing the macroeconomy, stimulating demand, and ensuring social justice. The data is unequivocal: the people of Pakistan are already funding a massive, parallel welfare state worth over PKR 600 billion. The potential exists to triple this amount to PKR 3 trillion—enough to wipe out extreme poverty and reduce dependence on foreign debt.

The proposal outlined here—a transition facilitated by tax rebates, public-private partnerships, and digital transparency—bridges the gap between the sacred and the secular. By recognizing Zakat as a valid contribution to the public good and integrating it into the fiscal framework, Pakistan can move from a predatory state to a facilitative one. This is the only viable path to ending exploitative taxation and building a prosperous, resilient, and just society.

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