



National  
Foreign  
Assessment  
Center

~~Secret~~

APPROVED FOR RELEASE  
DATE: AUG 2001

# Pakistan: Moving Toward an Islamic Economy

An Intelligence Memorandum

~~SECRET~~  
REF ID: A66555  
AUGUST 1960

FORM 000

**National Security  
Information**

**Unauthorized Disclosure  
Subject to Criminal Sanctions**

Derivative classification [REDACTED]  
Review six years from date  
Derived from multiple sources

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## **Pakistan: Moving Toward an Islamic Economy**

### **Summary**

President Zia has taken the first steps to reshape Pakistan's economy along Islamic lines. The budget for the fiscal year that began on 1 July 1980 includes provisions for implementing Koran-based taxes on wealth and agriculture. Both taxes are traditional Islamic tools for redistributing wealth and for discouraging hoarding. Under Islamic law, proceeds of the taxes can be used only for assisting the needy.

Zia is also establishing interest-free banking, another cardinal element of an Islamic economy. Islamabad is introducing an interest-free system in several areas of finance and is establishing facilities for accepting interest-free bank deposits. Many Muslims interpret the Koran as prohibiting all interest and instructing those who lend to share in profits—and losses—instead of being guaranteed a fixed return in interest.

Complementing these measures, the government is introducing a type of interest-free bond and is exempting companies from income tax if they are organized along traditional Islamic lines and if 90 percent of their income is distributed to participants in the company.

It is unclear how far and how fast Zia intends to move the economy closer to the Islamic pattern, partly because any definition of an Islamic economy is highly subjective. Pakistan's Shia minority, which comprises some 20 percent of the Sunni-dominated Muslim population, has already resisted some of the new measures. Nevertheless, Zia believes the new measures will strengthen his Islamic credentials at home and abroad. Movement toward an Islamic economy provides the minimum prerequisite for continued political and financial support from the Arab world, and especially from Saudi Arabia.

## **Pakistan: Moving Toward an Islamic Economy**

### **Recent Developments**

The Zia government is moving closer toward instituting an Islamic economy. The recently announced budget for the fiscal year that began on 1 July 1980 includes provisions for implementing Koran-based taxes on wealth and agriculture and applying interest-free banking on a limited scale. Beginning his fourth year in power, Zia until now has been slow to adjust Pakistani life to Islamic teachings despite his public commitment to do so soon after overthrowing the Bhutto government in July 1977. Although Islamabad promulgated a harsh judicial code—which it claimed conformed with Islamic law—in 1979, steps to Islamize the economy largely remained in the realm of rhetoric. In part, Zia probably judged the economic and political environment too fragile initially following Bhutto's ouster and later his execution in April 1979. Another and more practical consideration almost certainly has been the conceptual nightmare of interest-free banking, a subject that has bedeviled Islamic scholars for several hundred years.

How far and how fast Zia intends to move Pakistan's economy along the Islamic path is unclear. Although any definition of an Islamic economy is highly subjective, Zia's concept has focused only on Islamic-based taxes and the prohibition of interest, as described in Islamic teachings. A national commission established by Zia is studying the revision of Pakistan's commercial and civil laws to bring them into conformity with Islamic law, but completing this task is at least several years away.

### **The Call for an Islamic Economy**

Pakistan and Islam have been inexorably linked since the nation was created 33 years ago when India was partitioned. In pre-independence India, some 25 percent of the population was Muslim and it was for Muslims that the early leaders of the Pakistani movement for an independent state claimed to speak. Islam was effective in creating Pakistan because Muslims in undivided India feared domination by the majority Hindus, and educated Muslims sought their own state in which to develop what they believed a true Islamic society should be. Thus, with the reluctant acquiescence of British and Hindu leaders, Pakistan was pieced together out of those areas of the subcontinent that were predominantly Muslim.

Zia is not the first Pakistani national leader attempting to tap the wellspring of Islamic fundamentalism. *Nizam-I-Islam* (life according to the teachings of the Prophet Muhammad) has been the byword of Pakistani politicians since independence. *Nizam-I-Islam* lay dormant as a policy issue after the death of Pakistan's founder, Muhammad Ali Jinnah, in 1948, however.

Postindependence problems of economic development that faced Western-educated Pakistani leaders overshadowed the religious and social needs of Pakistan's Muslim community, which constitutes 97 percent of the 85 million population. [REDACTED]

The idea of an Islamic state resurfaced in the 1970 election campaign of President Zulfikar Ali Bhutto. Although *Nizam-I-Islam* at first was used against Bhutto by opposition religious leaders and devout Muslims, Bhutto expediently committed his government to *Islamic Socialism* and won a sweeping election victory. Popular doubts about the seriousness with which Bhutto practiced Islam nonetheless remained, and his failure to move the promise of an Islamic state beyond political symbolism partly explains his overthrow by General Zia in 1977. [REDACTED]

The concept of an Islamic economy has been open to widely different interpretations among Pakistani scholars as well as scholars throughout the Islamic world. This reflects the lack of a specific economic theory put forth by Islam, which offers only guidelines for many kinds of economic behavior that should be viewed as the theoretical ideal. Islam calls for justice and moderation in consumption, while scorning monopoly power, inefficient use of resources, and gambling.<sup>1</sup> The objective of an Islamic economic system is to secure the widest and most beneficent distribution of wealth through institutional arrangements and moral exhortation. Since all forms of wealth are the gift of God to all mankind, each individual is required to share his wealth with the community. At the same time, Islam recognizes differences in talents—and consequently economic rewards—among people, but it demands that each individual be responsible not only to himself but also to those less endowed and to society as a whole. As such, it is the duty of an Islamic state to ensure at least a subsistence level of existence for all its citizens by, if need be, redistributing wealth from the rich to the poor. [REDACTED]

### Zia and Islamic Economics

Zia, a devout orthodox Muslim, made his first move to bring the economy closer to the Islamic pattern in February 1979. He announced with much fanfare, that the government intended to impose two basic Islamic fiscal measures—*zakat* (a tax on wealth) and *ushr* (a tax on agricultural production). Both taxes are traditional Islamic tools for redistributing wealth and discouraging hoarding. [REDACTED]

[REDACTED]

*Zakat*, as one of the "five pillars of Islam," is an indispensable requirement for an Islamic state.<sup>2</sup> As specified in the Koran, *zakat* is a voluntary annual levy on personal wealth. According to Islamic law, it can be used only for the benefit of the poor and the promotion of Islam. *Zakat* clearly fits in with Islamic concepts of state and individual social responsibility for the basic human needs of disadvantaged Muslims. Zia, however, is implementing a *zakat* that is more than voluntary. Besides a 2.5-percent self-assessed tax on personal property, the government is levying an annual compulsory 2.5-percent tax collected at the source on most savings deposits over \$100, although allowing exceptions for widows, the needy, and other special circumstances. Zia also originally wanted a blanket application of the tax to financial instruments, such as stocks and insurance policies, and retirement funds, but was told by Islamic scholars that this would not accord with Islamic precepts if the funds are the sole source of income for widows, the aged, and the needy. As a result, applying the tax on these financial instruments will be decided on a case-by-case basis. In addition, the tax will not be paid annually but at maturity for savings certificates or at the time of sale for stocks and bonds.

Collection and distribution of *zakat* is administered by a five-tiered structure of committees ranging from the national to the local level. At the national level, Islamabad prefers that most of the 16-member committee be composed of Islamic religious scholars. The chairman of the committee is nominated by the President and must be a sitting judge on a high court or the supreme court. At the other levels, the committees consist of a combination of lay scholars, clerics, and ordinary citizens. Approximately 32,000 local *zakat* committees have been established. Taxes collected at the source will go to the national committee, while those collected on a self-assessment basis go to the local committees, who are responsible for enforcing collection.

*Ushr* is of less symbolic importance than *zakat*. Nonetheless, it has a long history as a source of revenue for Islamic treasuries. Traditionally, *ushr* was collected from Muslim farmers at harvesttime on crop output in excess of production costs. The levy was based on the kind of crop, productivity of the land, and cost of production.

Zia's version of *ushr* is a 5-percent mandatory tax on farmers. The tax will apply to each crop a farmer grows; for example, if a farmer grows wheat, beans, and millet, each crop will be separately taxed to the extent its output

<sup>2</sup> The other four pillars are fasting during the Ramadan holy month, praying five times a day, making a pilgrimage to Mecca during one's lifetime, and professing the faith verbally.

exceeds 948 kilograms of wheat or its equivalent; one-fourth of output over 948 kilograms will be treated as a cost of production and exempt from *ushr*. All landowners are subject to the tax, but whether it will be applied to tenants and sharecroppers is still under consideration. Farmers of rain-fed land will be required to pay an additional 5-percent tax because they are now exempt from paying water taxes. Local committees are responsible for assessing and collecting *ushr*. Although Zia intended to begin applying *ushr* at the same time as *zakat*, collecting the tax probably will be delayed until at least mid-September 1980 while some fine points still being debated by Islamic scholars and administrative details are resolved.

### Wrestling With Interest

The most difficult and contentious reform proposed by Zia for a fully Islamic economy is the abolition of all interest charges and associated reform of the banking system. From the start, Islamabad faced serious conceptual problems laying out the rules for an interest-free economy that Zia hoped to have in effect by 1982. Islamic scholars themselves are divided on the interpretation of Muhammad's proscription against interest payments. Some interpret the Prophet's commentaries on the financial abuses of his age as prohibiting all charges that even remotely resemble interest; others interpret the doctrine more loosely, as the prohibition on usurious charges only.

Although Islamabad was working on a format for applying interest-free banking in 1978-79, Zia decided to introduce the concept on a very small scale. The government implemented interest-free housing loans for lower grade civil servants, interest-free loans for bicycle purchases, and interest-free loans for subsistence and tenant farmers. Although the housing and bicycle loan program are touted as interest free, they are not. As is common inside Saudi Arabia, the prohibition against interest is circumvented by the borrower's making a supplementary "gift" when paying back the loan.

Islamabad is now implementing a broader application of interest-free banking. While the government is emphasizing phasing in the concept, in the budget message Finance Minister Ghulam Khan said that Islamabad wants this "first" package of policies and actions large enough to bring about a basic change in the situation . . . and a foundation be clearly laid." As such, the government is introducing an interest-free system among several specialized government-owned financial entities, and in selected areas of corporate finance and lending to small business firms. In addition, interest-free lending in the agricultural sector will now include fishing and interest-free loans will be available for irrigation improvement projects.

Lastly, commercial banks will establish separate counters for accepting interest-free deposits that will be invested in financial instruments such as export and import bills and letters of credit. [REDACTED]

Application of interest-free banking in these areas will be based on the long-established Islamic tenet that those who lend should share in profits—and losses—instead of being guaranteed a fixed return in interest. Thus to conform corporate financing with Islamic law, the government is introducing the "participation term certificate" to replace interest bearing debentures. Holders of these certificates will become participants in the profits of the company for a period not to exceed 10 years and the certificates will be secured by a lien on the company's fixed assets. On the deposit side, interest-free accounts presumably will operate in much the same manner as banks with similar facilities already established in countries such as Dubai, Saudi Arabia, Sudan, and Egypt. These facilities invest most of their capital in profitmaking enterprises and share profits on loans among depositors in proportion to the size of the depositor's account. [REDACTED]

Islamabad is also introducing the *mudaraba*, a form of business organization that was prevalent in Muhammad's time, in the corporate sector. In Islamic law, the *mudaraba* is a contract between two parties, one of which provides the financial capital for a venture and the other which operates the enterprise. Profits and losses are distributed according to fixed, contracted shares. On different levels, *mudaraba* can be, for example, between a bank that provides financing (but does not participate in the business) and an entrepreneur who manages the operation. On a smaller scale, *mudaraba* could be between an entrepreneur who provides the capital and a laborer who performs the day-to-day work. In the latter case, the worker could negotiate beforehand to receive a fixed share of the profits in lieu of a wage. *Mudaraba* is approved by some Muslim jurists as ideal for an Islamic economy because it recognizes disparities in wealth, encourages use of idle capital, and gives both entrepreneurs and laborers a greater incentive to work. [REDACTED]

As envisaged by Islamabad, companies, banks, and other financial institutions will register as *mudaraba* companies and float *mudarabas* for specific or general purposes. Because the business activities of *mudarabas* will be restricted to those approved by Islamic law, they will require approval from a newly established religious board. The entire income of *mudarabas* will be exempt from income tax, provided that 90 percent of the income is distributed to the participants. [REDACTED]

<sup>3</sup> In practice, however, some Islamic banks guarantee their depositors minimum fixed rates of profit return. To strict interpreters of Islamic tenets the practice is tantamount to paying interest, and as such is condemned. [REDACTED]

## Impact of the Measures

Islamabad is confident that the new interest-free measures can be implemented without serious disruption to production, trade, and a financial system that until now has operated exclusively with a Western-style commercial banking system. Even if its optimism is borne out, Pakistan still faces difficulties in integrating an interest-free system with the conventional international financial community, on which the country depends for much of its development financing. At present, Islamabad does not intend to act in this area and has taken steps to forestall concern by multilateral lending agencies such as the Asian Development Bank and the World Bank. Islamabad has assured these institutions that foreign loans will not be affected by the new measures, and domestic development finance institutions that obtain foreign credits will continue their traditional mode of banking. [REDACTED]

The government expects the new Islamic tax measures to yield about \$300 million annually, of which \$200 million would be generated by *zakat*.<sup>4</sup> Land and wealth taxes now yield about \$25 million annually. The current low yield reflects extensive exemptions and widespread tax evasion. Largely because of uncertainties about the yield of the new taxes, Islamabad at present does not plan to include them in the government budget. Nonetheless, when the yield becomes more precise, Islamabad will consider reducing its social welfare outlays to compensate for spending on these services from the Islamic taxes. The new taxes will also result in an estimated \$15-\$20 million reduction in government tax revenues because (a) amounts paid as *zakat* can be deducted from income taxes, (b) assets subject to *zakat* will be excluded from the existing wealth tax, and (c) land taxes have been abolished in lieu of paying *ushr*. [REDACTED]

Zia has acted quickly to collect the *zakat* at the source. In a surprise move Islamabad closed the banks on 21 June 1980 to deduct the compulsory 2.5 percent levy on most savings accounts over \$100. Preliminary estimates indicate that the yield was \$50 million. Zia moved with equal speed ordering distribution of \$25 million on 15 July 1980, the first day of Ramadan, to an estimated 750,000 Pakistanis.<sup>5</sup> Although only Muslims are liable for paying *zakat*, reports indicate that the small number of Pakistanis belonging to other religious faiths are eligible to receive *zakat* payments. [REDACTED]

Even if revenues from the new taxes reach the levels anticipated by Islamabad, they will be stretched thin. In addition to the projected \$300 million domestic yield, Pakistan garnered a \$200 million contribution for

<sup>4</sup> Total central government tax revenues are now averaging \$2.6 billion annually, an amount equivalent to 14 percent of GNP. [REDACTED]

<sup>5</sup> The holy month of Ramadan is the ninth month of the Muslim year, which is devoted to prayer and fasting from sunrise to sunset. [REDACTED]

the *zakat* fund from Saudi Arabia. Although the funds were delivered in September 1979 and February 1980, Islamabad used the contribution for direct balance of payments support, thereby subverting its Islamic welfare aims.\* Assuming a \$500 million *zakat* fund was available, however, it would translate into per capita outlays of less than \$20 for the poorest 40 percent of the population, which accounts for roughly 30-35 million people [REDACTED]

*Ushr* is likely to have an adverse but as yet unmeasurable impact on farm output. The agricultural sector is now only lightly taxed, yet little margin exists to absorb taxes among most of the Pakistani farmers. For example, although implementation of *ushr* is on the horizon, Islamabad is reducing fertilizer subsidies which means higher input costs for farmers. Assessing *ushr* will probably prove an administrative nightmare. Many small farmers do not keep good records, and the local committees are likely to run into the same administrative problems with which the government tax authorities have to contend. It would be surprising if *ushr* does not reduce incentives, morale, and purchases of needed inputs to agriculture [REDACTED]

### The Political Fallout

The new tax measures have drawn a mixed response. By far the sharpest reaction occurred in early July when 35,000 Shia Muslims protested against the taxes in Islamabad. The Shias, which comprise some 20 percent of the Sunni-dominated Muslim population, were offended by the compulsory provision of *zakat*. They argued that compulsion is not in accordance with Islamic teachings which say the tax should be voluntary. After discussions with Shia leaders and in return for calling off the demonstrations, Zia agreed to meet their demands. He promised to amend the law by mid-September, making the taxes voluntary for the Shia minority. [REDACTED]

The episode caused a loss of face for the regime, however, and sets a potentially dangerous precedent. Some political observers in Pakistan believe that other sects or minorities may now be emboldened to press their cases on specific issues. The Shia leaders reportedly believe that they have successfully defeated the government on a basic Islamic issue. [REDACTED]

Less-strict Muslims are taking refuge in the possibility of minimizing the self-assessed share of the *zakat* and avoiding the compulsory levy on savings accounts and other financial assets. For example, as early as March-April 1979, soon after *zakat* was seriously proposed, rumors developed that

\* For further details on balance of payments problems see CIA, ER 80-10324, *Pakistan, Perspectives on Economic Aid*, May 1980, Secret. [REDACTED]

middle-class Pakistanis were withdrawing money from banks and reportedly sending the funds abroad. As yet, there have been no signs of capital flight since the new tax measures were announced in the budget. [REDACTED]

Despite the Shia incident, the government is attempting to get as much political mileage as possible from implementing the new tax and interest measures. Islamabad is aiming its message at the great majority of poor Pakistanis since they in principle will benefit from the taxes. From Islamabad's perspective, the new measures should satisfy those elements in Pakistan's society seeking some demonstration of the government's Islamic commitment and signs of social and economic reform. Zia sees the new taxes as "the cornerstone of the Islamic welfare system... that... not only prevents concentration of wealth in a few hands but also meets the needs of the poor." [REDACTED]

Zia almost certainly considers the new measures as strengthening his Islamic credentials abroad, as well as domestically. He probably views the practical movement toward an Islamic economy as a minimum prerequisite for continued political and financial support from the Arab world. This is particularly true for relations with Saudi Arabia which has emerged as Pakistan's staunchest Muslim ally following the Soviet invasion of Afghanistan. Zia's use of the Saudi *zakat* contribution for balance of payments support apparently has not troubled Riyadh, [REDACTED]

[REDACTED]

<sup>7</sup> For details on Pakistan's economic relations with Saudi Arabia, see CIA ER 80-10095, *Pakistan, the Middle East Connection*, February 1980, Secret Noform. [REDACTED]

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