International Journal of Multicultural and Multireligious Understanding

http://ijmmu.com
editor@ijmmu.com
ISSN 2364-5369
Volume 12, Issue 7
July, 2025
Pages: 58-64

Tax Policies to Direct Liquidity Toward Investment in Production Within the Islamic Economy

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http://dx.doi.org/10.18415/ijmmu.v12i7.6979

Abstract

One of the major economic challenges in Iran in recent decades has been the increasing volume of liquidity, which has caused significant economic problems. One of the key solutions to address the issue of rising liquidity is directing liquidity toward productive investment through tax policies implemented by the government. The objective of this research is to examine tax policies that channel liquidity into productive investment within an Islamic economy. This study conducted using a descriptive-analytical method and relying on library-based sources, explores tax policies, liquidity guidance, productive investment, and various types of Islamic taxes. It also investigates how liquidity can be directed toward productive investment in an Islamic economy through tax policies. Based on the research findings, both types of governmental taxes—income taxes and regulatory taxes—are suitable for steering liquidity into productive investment. Key regulatory tax instruments such as capital gains tax, reduced taxes on production, and value-added tax (VAT) play a crucial role in directing liquidity toward investment in productive sectors of the economy. These measures help prevent the flow of liquidity into unproductive economic activities.

Keywords: *Investment for Production; Tax Policies; Regulatory Taxes; Government Taxes; Liquidity Management*

JEL Classification: E22, G32, H21, H71, E52

Introduction

One of the major economic challenges Iran has faced in recent decades is the significant increase in liquidity volume, which has led to numerous economic problems, including the depreciation of the national currency and economic stagnation, rising inflation and exchange rates, an uncertain economic environment, widening class disparities, and unequal distribution of wealth and income.

One of the key solutions to address the issue of rising liquidity is directing liquidity toward productive investment through the government's implementation of tax policies. This approach is based on the premise that the government, by utilizing tax adjustments and imposing regulatory taxes, can steer liquidity toward productive economic activities and prevent its flow into unproductive sectors. This strategy, on the one hand, reduces liquidity in the economy and, on the other hand, increases the production of goods and services. As a result, inflation decreases, while the value of the national currency, production, employment, and economic growth increase.

In the Islamic economic system, government intervention in economic activities is not limited to overseeing the proper implementation of laws and regulations. Rather, the government can establish regulations to manage economic affairs and make decisions in areas where prohibitions or obligations have not been explicitly declared. Therefore, while adhering to fixed laws and regulations, an Islamic government possesses broad authority to enact regulations and has the capability to address economic issues and challenges (Namazi, 2003, p. 330). However, how an Islamic government can use tax policies to direct liquidity toward productive investment and economic activities while preventing its diversion into unproductive sectors remains a subject requiring further research. The objective of this study is to examine tax policies for directing liquidity toward productive investment in an Islamic economy. While some related research has been conducted, given the importance of this topic, additional studies are necessary.

The research questions are as follows: What are the tax policies for directing liquidity towards productive investment in an Islamic economy? How do tax policies channel liquidity into productive investment in an Islamic economy?

This research, conducted through a descriptive-analytical method using library resources, first examines tax policies, liquidity guidance, productive investment, and various types of Islamic economics. It then explores how tax policies can direct liquidity towards productive investment within an Islamic economic framework.

Tax Policies

Tax policy is a component of fiscal policy. Fiscal policy refers to a set of decisions and measures implemented by the government to influence overall economic activities (Tafazzoli, 2009, p. 477). Alternatively defined, fiscal policy consists of government actions that manifest as changes in government expenditures and revenues. Government revenues include taxes, while government expenditures comprise public spending, transfer payments, and cash or in-kind subsidies (Rahmani & Asadollahzadeh, 2015, p. 154).

Thus, "tax policies" constitute a set of government decisions and measures regarding tax adjustments aimed at achieving economic objectives. Furthermore, "tax policies for directing liquidity toward productive investment in an Islamic economy" refer to government decisions and measures concerning tax modifications designed to channel liquidity into investments for producing goods and services required by society within an Islamic economic framework.

Liquidity Management

"Liquidity" is the sum of money supply and quasi-money. The money supply includes coins and banknotes in the hands of the public plus private sector current deposits in banks, while quasi-money consists of savings deposits and time deposits (Shakeri, 2008, p.24).

Liquidity = Money + Quasi-money

According to this definition, liquidity includes all money held by individuals and the private sector, whether in their possession or in bank accounts. For depositors themselves, bank time deposits are considered quasi-money; however, for banks, they constitute money that can be used for granting loans and investments whenever needed.

"Directing liquidity" means channeling and moving existing liquidity in the economy toward desired economic activities. Here, however, "directing liquidity" specifically refers to steering liquidity toward investment in productive sectors of the economy that produce goods and services needed by society, while preventing its flow into unproductive economic sectors and speculative activities.

Directing liquidity toward productive investment means that the government, through tax policies and instruments, creates conditions for investment in productive economic sectors and the production of goods and services. This encourages individuals and legal entities to invest their excess liquidity in producing goods and services needed by society while avoiding investments in unproductive and speculative activities.

In liquidity direction, beyond controlling the money supply, the objective is to reallocate the money supply across various economic sectors (Davoudi & Samsami, 2009, pp.265 & 281). Liquidity direction essentially represents solutions and remedies that ensure existing liquidity in the economy is channeled toward sectors that need it - contributing to their growth and development - rather than being misused, remaining idle, or harming the economy. Tax policies for directing liquidity can be employed under any circumstances, particularly during periods of increasing liquidity and inflation (Hosseini, 2002, pp.373-374).

Investment for Production

The term "production" lexically means bringing into existence, processing, yielding, generation, giving birth, constructing, establishing, creating, product, and output. In the terminology of economic science, production has various definitions, such as: preparing needed goods and services using available resources and facilities; the series of actions taken to transform resources into required goods; all operations and activities that ultimately result in creating desirable goods or services, with this desirability potentially taking various forms (Hariri, 2009, vol. 2, p. 803); creating utility and desirability to satisfy individuals' needs; and a sequence of human activities through which production factors are combined to provide the goods and services required by individuals (Ghannadan, 2007, p. 104).

According to both lexical meanings and technical definitions of production, from an economic perspective, production means creating new and needed goods and services - such as constructing roads, dams, factories, and buildings, or establishing production workshops, all of which represent new goods needed by society. Similarly, services provided by doctors, teachers, and repair technicians are also considered production in economic terms, since the purpose of all these individuals in providing such services is to satisfy people's needs. Moreover, services performed within goods distribution networks, including wholesale, retail, and transportation of goods and passengers, are also accounted as part of the production network, because these services complement goods production in reaching consumers.

Therefore, the concept of production in economics, in addition to creating new goods and services, includes all services that contribute to enhancing the utility of goods and services and making them available when needed by people.

The term "investment" has been defined in various ways in economic terminology dictionaries, such as: deploying and combining factors of production to increase the output of goods and services; employing financial resources in productive activities to generate profit; using money to earn income and increase capital (Hariri, ibid., p. 1071); the flow of resources into creating new capital; the aggregate of capital goods or durable goods employed to produce consumer goods or capital goods for satisfying future consumer needs; the actual production of capital goods within a specific timeframe, such as constructing a new road or establishing a new production line in a factory. However, generally speaking, investment refers to any application of capital with the expectation of generating income. (Tavanaianfard, 2006, pp. 527-528)

Investment is of two types: productive investment and unproductive investment.

"Productive investment" refers to investments that lead to increased production levels, resulting in new goods and services and creating value-added in the economy (Hariri, ibid., p. 1083). This type of investment increases employment, improves economic growth, and promotes sustainable development. Examples include investments in industries, factories, production equipment, educational services, healthcare, and transportation networks - such as building steel mills, automobile manufacturing plants, refrigerator factories, agricultural equipment facilities, hospitals, and schools, as well as repair services, goods distribution, and passenger transportation services.

"Unproductive investment" refers to investments that do not lead to increased production levels, creation of new goods and services, or value-added in the economy, but rather only generate short-term profits. Examples include buying and selling land, housing, vehicles, gold, and foreign currencies for income generation purposes, which do not result in the production of new goods and services.

Considering the meanings and definitions of investment and production, "investment for production" refers to investing in the productive sector of the economy and utilizing existing liquidity to produce new goods and services needed by society.

Among the characteristics of productive investment are that it creates stable, long-term profits; increases employment; generates value-added in the economy; reduces import dependence; and ensures long-term economic growth and development.

Productive investment occurs across various broad sectors of the economy, each playing a vital role in the country's growth and development. Here we mention some of them:

a) Investment in financial markets: Such as purchasing shares of production and service companies and buying participation bonds for industrial and infrastructure projects;

b) Investment in the production sector: Such as establishing factories and industrial workshops for producing domestic goods;

c) Investment in the service sector: Such as building hospitals, medical centers, and insurance services; education in schools, universities, and educational institutions; information technology, software development, and digital services; and expanding public transportation networks;

d) Investment in infrastructure: Such as constructing roads, bridges, and highways to improve transportation and trade; power plants, renewable energy sources, and electricity distribution networks; developing telecommunications infrastructure; and civil projects such as dams, railways, and metro lines;

e) Investment in the agricultural sector: Such as establishing mechanized farms, using modern agricultural technologies, implementing advanced irrigation systems and water consumption optimization, developing processing and packaging industries to reduce waste and increase value-added, and supporting the production of organic and healthy products.

These investments, in addition to creating job opportunities and increasing production, also help improve quality of life and reduce economic dependencies.

Islam places great importance on capital and investment, considering capital as a pillar of people's livelihoods and encouraging them to invest in productive and constructive activities. Islamic teachings emphasize and encourage directing liquidity toward production and utilizing capital in productive activities while prohibiting the idle hoarding of capital. Islam also stresses the proper and optimal use of wealth and entrusting assets to individuals with the necessary intellectual and economic maturity, while prohibiting the handing over of wealth to the foolish and incompetent. The appropriate use of capital must be determined through expert analysis, and informed, wise decisions must be made in this regard. (Hosseini, 2002, p. 387)

God Almighty said in the Holy Quran:

> "And do not give the foolish your property which Allah has made a means of sustenance for you." (An-Nisa, 5)

Imam al-Sadiq states:

> "The survival of Muslim society and the preservation of Islam depend on placing wealth in the hands of those who recognize obligations, understand priorities, and achieve optimal utilization and productivity of resources." (Al-Kulayni, 1986, Vol. 4, p. 26)

Imam Ali declares:

> "Limited financial capital achieves significant growth through proper planning." (Al-Amidi, 1989, p. 354, Hadith 8081)

Imam al-Sajjad affirms:

> "All nobility lies in making wealth (and capital) profitable and fostering its growth." (Al-Majlisi, 1982, Vol. 75, Chapter 21, p. 141)

Economic experts and scholars similarly emphasize - particularly during periods of liquidity expansion and the widening gap between monetary growth and production growth - the necessity of channeling liquidity toward developmental initiatives, essentially advocating optimal resource allocation in the economy. There is consensus on the strategy of "directing liquidity toward productive sectors" and "investment for production" (Khamenei, 10/12/2020).

When liquidity under such conditions is channeled toward productive activities while prevented from flowing into non-productive and speculative ventures, it strengthens national production, generates employment, reduces inflation, and enhances economic growth. Governments may utilize Islamic taxation mechanisms to implement fiscal policies that direct liquidity toward productive investments.

Types of Islamic Taxes

Taxation (derived from the Arabic "mālīya") in economic science refers to a portion of income, wealth, sales, or any other legally defined base that is collected by the government from individuals and legal entities. (Farhang, 1975, Vol. 1, p. 371)

Some scholars define tax as an amount that the government collects from individuals, companies, and institutions according to law to strengthen public governance and meet general expenditures. (Arab-Mazar, 1997, No. 16, p. 24)

Certain Islamic theorists have defined Islamic taxation (mandated by religious law) as follows:

> "Islamic tax is a determined right that Islamic legislators have obligated on individuals' wealth. This right is collected in cash or in-kind according to specified conditions and based on financial

directives, and every individual - whether under the protection of the Islamic government or outside it - is obligated to pay the due right upon them." (Azizi, 2011, p. 317)

One of the important duties of an Islamic government is tax collection. The Islamic ruler requires a budget for administering the government and society as well as meeting the public needs of the community, and taxation represents one of the best methods for budget provision. Therefore, Imam Ali considers tax collection as the primary duty of a ruler and instructs Malik al-Ashtar to collect it: "This is the command of the servant of God, Ali, the Commander of the Faithful, to Malik Ashtar, son of Harith, in the covenant he has with him, when he appoints him as the governor of Egypt to collect the tribute of that land." (Nahj al-Balagha, letter 53)

In another part of this treatise, Imam Ali mentions the importance of taxes: "The affairs of the people are not established except with the armies. The stability of the armies is not achieved except through tribute and taxes from the subjects, with which they are strengthened for jihad against the enemy and rely on it to improve their affairs and meet their needs." (Ibid.)

Therefore, taxes are among the most important financial resources of the government, functioning like blood in the veins of a government's life. This is because economic strength is among the most fundamental foundations of a government's stability and firmness, and enhancing the government's executive capacities is made possible through taxation.

In modern economics, while taxes remain one of the most important financial resources for governments, they also serve as a key instrument in fiscal policies for directing liquidity towards productive investments. Similarly, in Islamic economics, various types of taxes exist that the government can utilize to channel liquidity into investments in productive activities.

Fourteen centuries ago, Islam established various types of taxes, such as lump-sum taxes, proportional taxes, regressive taxes, poll taxes, income taxes, consumption taxes, wealth taxes, savings taxes, profit taxes, land taxes, agricultural product taxes, taxes on idle money, taxes on specified livestock, and taxes on mineral extractions.

Islamic taxes are broadly classified into two categories: legislative taxes (prescribed by Sharia) and governmental taxes (determined by the state).

Legislative Tax

Legislative taxes are those taxes that have been established through primary and direct legislation by the divine lawgiver (Sharia), with specific subjects, amounts, or rates determined for them. These taxes include the following:

a) Zakat: Zakat means growth, development, and purification. According to Quranic verses and hadiths, zakat is a financial obligation established for the purification and spiritual elevation of individuals, as well as for providing financial support to the needy. It leads to increased sustenance, abundance of wealth, and economic security in society. (Karami & Pourmand, 2007, p. 157)

Zakat is of two types: Fitrah zakat and wealth zakat. Fitrah zakat consists of approximately three kilograms of food items such as wheat, barley, and rice, which becomes obligatory for each individual at sunset on the eve of Eid al-Fitr (Modarres, 2002, p. 212). Wealth zakat refers to the annual zakat obligation on certain types of wealth (Office of Cooperation between Seminary and University, 2000, p. 356). Zakat is obligatory on nine items: the four grains (wheat, barley, dates, and raisins), the three livestock (cows, sheep, and camels), and the two currencies (gold and silver). (Ghaffari, 2007, p. 72)

b) Khums: Khums means one-fifth and, in Islamic terminology, refers to a tax equivalent to one-fifth that Sharia has specified in certain cases. Khums applies to seven categories: "business profits, minerals, treasures, lawful wealth mixed with unlawful wealth, gems obtained through diving in the sea, war booty, and land purchased by a protected non-Muslim (dhimmi) from a Muslim." (Khomeini, 1989, p. 326)

c) Jaziya: Jizya is a poll tax collected from the People of the Book (ahl al-kitab) residing in Islamic territories and from non-Muslims living under the protection (dhimma) of the Islamic state. In return for protecting the lives and property of these citizens, the Islamic government levies this tax called jizya. (Ghaffari, ibid., p. 87)

d) Kharaj: Kharaj is a tax imposed by the Islamic government on kharaj lands, meaning lands acquired from non-Muslims through conquest. In other words, kharaj refers to income received as rent from agricultural lands and orchards that were collectively owned by all Muslims, as well as taxes on other cultivated lands or orchards of non-Muslims that were captured during war and became part of the collective property of Muslims (Sadr, 2008, p. 94). When non-Muslim lands were conquered and annexed to Islamic territories, these lands came under the ownership of the Islamic state. The Islamic government, in exchange for allowing individuals to use these lands, collected kharaj from them. (Ghaffari, ibid., p. 90)

Government Tax

Governmental taxes are those taxes that the Islamic ruler imposes in specific cases and circumstances, where the sacred Sharia has not determined a specific amount or rate for them. Rather, they are subject to necessary expenditures or based on considerations that the Islamic ruler deems appropriate (Office of Cooperation between Seminary and University, 2000, p. 383). Governmental taxes serve as a tool that allows the Islamic ruler, in various circumstances, to address the problems of Islamic society and employ them in matters aligned with the Islamic system's objectives (Lashkari, 2001, p. 227).

There is no specific text regarding governmental taxes that defines their limits, and their determination is entirely at the discretion of the government to collect from people according to need (Ma'refat, 1997, No. 10, p. 19). The tax on horses during the time of Commander of the Faithful Ali is an example of a governmental tax. Governmental taxes are equivalent to absolute taxes in conventional economics. Regulatory taxes also fall under governmental taxes, and the justifications for governmental taxes include regulatory taxes as well.

Justifications for Governmental Taxes

By referring to jurisprudential texts and the religious basis of taxation, numerous and diverse justifications are used to establish the legitimacy of governmental taxes. Here we mention three of these justifications.

1. Hadiths

Muhammad ibn Muslim and Zurarah have narrated from Imam Baqir and Imam Sadiq: imam Ali imposed two dinars annually on every horse that grazes in the meadows, and one dinar annually on pack horses." (Koleyni, 1986, vol. 3, p. 530, h. 1; Horameli, 1993, vol. 9, p. 77, h. 1)

Based on the apparent meaning of this narration, the Commander of the Faithful, Imam Ali, imposed a tax on the mentioned horses that had not been previously established. The evidence that this was a governmental tax lies in the narration's statement that he imposed two dinars for one type of horse and one dinar for another with specified characteristics, which indicates the establishment of a tax.

This ruling falls under the Islamic state's governmental decrees and taxes and can be considered among the examples of wealth taxes or taxes on the use of public resources such as pastures. Therefore, the Islamic government, when necessary and according to considerations of public interest, may impose annual taxes on certain properties and goods. In the early Islamic period, it was horses, while in our time, it could be cars or other items.

In an authentic narration reported by Ali ibn Mahziyar from Imam al-Jawad, a special tax is mentioned which Imam al-Jawad attributed to his own authority. The narration states:

"What I have made obligatory only for this year, the year 220... I have not made this khums obligatory for all years, nor have I made obligatory anything beyond the zakat that Allah has decreed. I have only made khums obligatory on gold and silver that has been in possession for a year, specifically for this year." (Hurr al-Amili, ibid., p. 501)

From the apparent meaning of this narration, it is understood that in addition to the taxes decreed by Allah, the Imam may establish taxes, and the tax imposed by Imam al-Jawad was of this nature.

2. Guardianship of the Islamic

Another method for proving the legitimacy of governmental taxes is through the foundation of "Wilayat al-Faqih" (Guardianship of the Islamic Jurist). The right of the Vali-e Faqih (Islamic Jurist Ruler) to impose taxes stems from political guardianship and the right to govern that has been delegated to him by God and the Infallible Imams. In other words: A qualified and just Islamic ruler possesses the same authority and competencies in managing Muslim affairs that the Noble Prophet of Islam possessed. The holy verse "The Prophet has a greater claim over the believers than they have over themselves" (Al-Ahzab:6) proves these authorities for the Prophet of Islam. This verse indicates that when the Prophet has priority over the believers themselves, then a fortiori he has priority over their wealth. Even beyond that, all affairs of Muslims are under the authority of the Prophet of Islam as the leader of society. Therefore, based on this leadership authority, he can collect a portion of believers' wealth as taxes. (Khomeini, 2000, Vol.2, pp.460-500; Rezaei, 2003, No.35, p.79)

Thus, the legitimacy of imposing and collecting taxes is based on the guardianship right that God has granted to the Islamic society's leader for administering society and the country. By accepting this foundation, there is no need for specific examples to exist in Sharia texts; rather, any matter required by contemporary expediency can utilize this foundation. Whenever the system based on Wilayat al-Faqih, which has been confirmed through legal channels, determines that collecting taxes serves society's interests - whether for covering various government expenses, society's growth and excellence, or regulating society's affairs - then imposing taxes becomes one of the enforceable governmental laws, and compliance with it becomes obligatory for all individuals.

The Constitution of the Islamic Republic of Iran also considers tax imposition as being based on law. Therefore, its imposition has religious legitimacy through the Vali-e Faqih's confirmation of the law. The various regulations related to administering society, such as traffic regulations, construction regulations, mandatory health requirements, etc., are of the same nature. (Khomeini, ibid.; Rezaei, ibid.)

Martyr Motahhari also considered tax legislation among the authorities of the Islamic ruler that is implemented according to temporal requirements and special conditions, writing:

"The question arises regarding zakat too - can the Islamic government impose something else as zakat or not? Yes, it can. The Commander of the Faithful (Imam Ali) imposed zakat on horses during his rule, and this is an established fact. Therefore, the Islamic ruler can include other specific things under zakat as well. If we accept nine items as fixed principles, it means those nine items certainly have zakat at all times and the Islamic ruler cannot reduce or increase them; those are fixed, while others are under the Islamic ruler's discretion, meaning under Islamic expediencies." (Motahhari, 2002, Vol.2, p.44)

Martyr Beheshti also writes in his book "Islamic Economics":

> "The requirement of our general jurisprudential principles regarding Wilayat al-Faqih and guardianship over Muslims is that if the Muslim ruler and government see that a necessary task has been neglected and requires expenditure, they determine specific rates; meaning they impose and collect specific taxes." (Beheshti, 1989, p.107)

3. Tax on the Use of Public Goods and Services

The government produces and provides numerous public goods and services for citizens' welfare and comfort; therefore, it has the right to collect payment for these goods and services from those who use them. The government provides services such as security, education, city cleanliness, maintaining order, and defending the territory and citizens while constructing goods like parks, roads, and cities. Producing these goods and services incurs significant costs that citizens must compensate through payments. In both religious and non-religious systems, taxes are collected to cover governments' operational expenses according to each country's specific regulations.

The government must strive in various dimensions essential for securing public interests and national welfare to govern effectively by providing necessary facilities and meeting public needs. A government that fails to meet its people's needs loses its legitimacy and will undoubtedly face imminent downfall.

Ayatollah Khamenei has stated:

> "The government requires extensive financial resources to manage national affairs across various cultural, military, economic and other dimensions, and without collecting taxes, it cannot secure the necessary budget to administer the country." (Ma'refat, 1997, No.10, p.23)

Esteemed jurists consider payment of governmental taxes as obligatory expenses and a form of compensation for government-provided goods and services to citizens.

When asked about tax evasion by individuals and companies, Ayatollah Khamenei responded:

> "Avoiding implementation of Islamic Republic laws and refusing to pay taxes, duties and other legal obligations to the Islamic government is impermissible for anyone." (Khamenei, 2002, p.794, Q.1990)

Ayatollah Makarem Shirazi, addressing whether taxes replace khums/zakat, explained:

> "The key point is that taxes represent operational costs for economic activities - using roads, benefiting from security, utilizing media and other public facilities. Without these, economic activities would be impossible or minimally productive. Therefore, paying a share of public service costs enabling one's business is natural. If nothing remains after taxes, no khums apply; the remaining profits belong 80% to the individual and 20% as khums primarily fund Islamic cultural preservation benefiting society. Thus, tax and religious obligation domains shouldn't be conflated." (Makarem Shirazi, 2004, Vol.3, p.115, Q.344)

Regarding another question about tax purposes, he clarified:

> "Taxes fund security maintenance, domestic/foreign defense ensuring citizen safety, plus infrastructure like roads, schools, hospitals, and social needs. Taxes cannot substitute khums but constitute standard business expenses." (Makarem Shirazi, Reasons for Taxation, Anhar Portal)

Types of Government Taxes and Liquidity Management

In modern economics, governmental taxes - which correspond to absolute taxes in conventional economics - represent one of the most important instruments of fiscal policy for liquidity management. Governmental taxes serve as a tool employed both for generating state revenue and regulating activities across various economic sectors. Consequently, governmental taxes can be categorized into two types based on their intended purpose: revenue taxes and regulatory taxes. Most Islamic taxes primarily serve revenue generation and distributive justice objectives, while some possess regulatory characteristics. Through modifications to revenue taxes and implementation of regulatory taxes, the government can effectively influence the direction of liquidity towards productive investments.

Income Tax and Liquidity Management

Revenue taxes are imposed and collected with the primary objective of generating government income and covering state expenditures. However, governments may also utilize revenue taxes as instruments for implementing fiscal policies to manage and direct liquidity.

When a government determines that the economy has entered a recessionary state due to declining incomes and reduced money supply and liquidity, it may implement expansionary fiscal policies by reducing taxes. Tax reductions increase liquidity within society, boost demand for goods and services, and consequently alleviate economic stagnation. Thus, any tax reduction leads to increased incomes and liquidity in society, enhances individuals' purchasing power, and ultimately raises aggregate demand for goods and services in the economy, pulling it out of recession. Expansionary fiscal policies through tax reductions may take various forms, including reducing or eliminating certain lump-sum taxes, granting tax discounts or expanding existing tax exemptions, temporarily waiving or canceling specific taxes and similar measures. By reducing taxes on productive economic sectors, the government can channel liquidity toward investments in these sectors.

Conversely, when a government identifies inflationary pressures and rising prices caused by excessive liquidity growth in the economy, it may implement contractionary fiscal policies by increasing taxes. Higher taxes reduce liquidity in society, leading to decreased demand for goods and services, which in turn lowers inflation and prices. Tax increases may take various forms, such as raising existing tax rates or introducing new taxes. By increasing taxes on unproductive economic sectors, the government can redirect liquidity toward investments in productive sectors.

Regulatory Tax and Liquidity Management

Regulatory taxes are imposed with the aim of market regulation and have a regulatory and behavioral-changing nature. Examples include taxes in the real estate sector aimed at controlling the real estate market, traffic fines imposed to control traffic violations, and capital gains taxes imposed to prevent speculation.

Governments also use regulatory taxes to manage and direct liquidity. By imposing taxes on harmful activities, they prevent liquidity from flowing toward them, while by reducing or exempting taxes on beneficial activities, they steer liquidity toward those sectors.

People and investors seek to maximize returns on their financial assets and will undoubtedly engage in markets that offer higher profitability. Thus, in recent years in Iran, highly profitable markets such as gold, foreign exchange, automobiles, and housing have seen increasing and irrational growth. The volume of transactions in these markets has risen, and instead of increasing the production of goods and economic growth, the surge in liquidity has fueled speculation and rent-seeking.

To change this situation, measures must be taken to increase the profitability of the productive sector relative to non-productive markets. If this increase is accompanied by a reduction in the attractiveness of non-productive and speculative markets—such as gold, foreign exchange, and automobiles—it will alter the investment landscape in the country and redirect excess liquidity toward the production of goods needed by the people. This redirection of liquidity increases the production of essential goods, leading to lower prices and reduced inflation.

One tool to achieve this goal is regulatory taxation. By imposing regulatory taxes on unproductive economic activities, increasing the cost of unproductive transactions, and reducing the cost of productive activities that meet societal needs, the path of liquidity and investment can be redirected. Tax incentives or taxation in different markets alter individual behavior and the allocation of financial resources. In summary, to influence investor behavior, the returns of non-productive and non-essential markets must be reduced through taxation, while targeted markets should be made attractive through incentives and support to encourage investor participation. (Pourreza Bavili, January 4, 2022)

Among Islamic legislative taxes, regulatory taxes also exist. Examples include khums on lawful wealth mixed with unlawful wealth, khums on land purchased by a dhimmi (non-Muslim under Islamic rule) from a Muslim, and expiations (kaffarah) for breaking a fast, vow, or oath—all of which have regulatory characteristics. The justifications for governmental taxes, including the principle of Wilayat al-Faqih (Guardianship of the Jurist), also support the permissibility of regulatory taxes to manage liquidity, direct it toward productive activities, and prevent its flow into unproductive sectors. Therefore, an Islamic government can impose regulatory taxes to manage liquidity in the Islamic economy, prevent economic disorder, and curb harmful public behavior.

Here, three regulatory tax tools are presented to direct liquidity toward productive investments and prevent their diversion into unproductive activities: capital gains tax, reduction of production taxes, and value-added tax.

Capital Gains Tax

One of the taxes that significantly influences the direction of liquidity toward productive economic sectors and boosts the production of essential goods and services is the capital gains tax on unproductive activities.

The capital gains tax is imposed on profits earned from investments in capital assets. Capital gains refer to all benefits or profits individuals obtain from holding an asset over time. The profit from capital is the difference between the selling price and the purchase price of an asset. Accordingly, the capital gains tax is defined as a percentage of the annual capital gain resulting from the increased value of capital assets—such as real estate, gold, and foreign currency—due to economic developments. The imposition of this tax is based on the notion that it can reduce investments in unproductive and speculative activities while increasing investments in productive sectors, thereby reducing wealth and income inequality. (Ghaemmaghami & Hedavand, January 17, 2023, No. 5649)

When an economy suffers from excess liquidity and inflation, investors anticipate future price increases. As a result, instead of investing in productive activities, they channel their funds into unproductive and speculative ventures such as real estate, gold, and foreign exchange. This behavior exacerbates inflation.

By imposing a capital gains tax, speculators are required to pay taxes on their transactions. For example, those trading gold or foreign currency must pay taxes, making such trades less profitable.

Consequently, they exit these markets and seek alternative investment opportunities. If productive activities offer higher returns, they shift their investments there. Thus, the capital gains tax eliminates the incentive for speculation and redirects liquidity toward productive activities, ultimately increasing the production of essential goods and services, lowering prices, and reducing inflation.

The capital gains tax is the most important global tool for preventing liquidity from flooding unproductive economic activities, thereby curbing excessive price hikes, market volatility, and speculative bubbles in parallel markets. By reducing the profit potential of speculation in currency, gold, real estate, and automobiles, the tax creates conditions for directing liquidity toward capital markets and productive economic sectors. Without curbing the excessive profits of unproductive activities, liquidity redirection will be ineffective. (Seyed Hassanzadeh, 2018, No. 312, p. 44)

Experts argue that one reason speculation is so attractive in Iran is that the country's tax system imposes high taxes on production and corporate profits, while speculators in currency, gold, automobiles, land, and real estate pay little to no taxes. This reality has led many investors, banks, and institutions to choose speculative and unproductive activities over investing in real goods production. Given that speculative profits in Iran often exceed the average returns of many productive activities, significant capital has been diverted from production to unproductive sectors. The most important tax tool to curb speculative activities is the capital gains tax. By reducing the profitability of speculation relative to real production, this tax encourages economic actors to invest in productive rather than unproductive activities (Torabifar et al., June 5, 2023; Donya-e-Eqtesad, 9/16/2009, No. 5453). Redirecting liquidity toward production and increasing investment in productive activities boosts the output of goods and services, leading to lower prices, reduced inflation, and higher economic growth.

Therefore, if properly designed, the capital gains tax offers numerous economic benefits, including: Reducing incentives for unproductive speculation, enhancing the appeal of real production investments, financing productive enterprises, increasing the production of goods and services, generating government revenue, promoting social justice, improving economic efficiency (Ibid.)

These economic functions of the capital gains tax play a fundamental role in efficient liquidity management, inflation reduction, and economic growth.

The capital gains tax has been in existence worldwide for over a century. By 2001, 114 countries had implemented it; by the end of 2017, this number rose to 187, and by 2023, it exceeded 190 (Zaer et al., 2018, p. 7; Safaei, June 5, 2024). In Iran, the capital gains tax bill was approved by the Islamic Consultative Assembly on May 1, 2023, with its design adhering to Islamic economic principles. (Mohammadi, May 21, 2024)

The permissibility of imposing a capital gains tax can be justified by the following arguments:

A) Khums on earned profits: Capital gains are a form of earned profit; thus, a 20% tax (khums) can be levied on them.

B) Government tax principles: The capital gains tax is a form of regulatory government taxation, and the principles of governmental taxation support its legitimacy.

C) The principle of preventing harm (Nafi al-Darar): Speculative economic activities harm the Islamic economy and society. According to this principle, such activities are prohibited, and preventing them is obligatory. One way to curb them is through the capital gains tax.

D) The principle of preventing economic disorder (Ikhtilal al-Nizam): If speculative activities disrupt the economic system, they are prohibited under this principle, and measures must be taken to prevent them—one of which is the capital gains tax.

Thus, the capital gains tax aligns with the foundations of Islamic economics and fulfills its objectives, such as lowering general price levels, and increasing employment, growth, security, justice, and economic welfare. It is, therefore, a suitable tool for fiscal policies aimed at directing liquidity toward productive investments in an Islamic economy.

Reduction of Production Tax

After preventing the influx of liquidity toward unproductive activities, it is essential to devise measures to channel these funds toward productive activities and investments in beneficial economic sectors, while creating favorable conditions for investors.

One regulatory tax tool that directs liquidity toward the production of goods and services needed by society is reducing taxes on production. This is because taxes reduce the profits of productive activities and diminish investors' incentives to engage in production, leading them to allocate their capital to unproductive and speculative ventures instead. However, by lowering taxes on production, the profitability of productive activities increases. This creates an incentive for liquidity holders to enter productive sectors and deploy their funds accordingly.

Although production units face numerous challenges in their initial stages—such as liquidity shortages and low capital returns—the tool of tax reduction can play a significant role in mitigating some of these issues. Additionally, reducing taxes on production enhances the working capital of existing firms, boosts employment, and increases the output of essential goods and services. (Vatan-e Emrooz, December 26, 2022, No. 3663)

Reducing taxes on production directs liquidity toward production and contributes to increased output and lower inflation in two ways:

1. Existing firms expand their production
2. New investors enter the production of needed goods and services

As the supply of goods and services rises, prices and inflation decline.

Tax reduction on production is endorsed by Islamic economics. The principles of governmental taxation support this approach. In fact, Imam Ali, in his letter to Malik al-Ashtar, advises reducing taxes on production:

If people complain to you about the burden of taxes, or crop blight, or the drying up of springs, or insufficient rainfall, or land damaged by flooding or severe drought, then reduce their taxes by an amount you hope will rectify their affairs and bring improvement. And never let the cost of such relief weigh heavily upon you, for indeed it is an investment that will return to you through the prosperity of your cities and the adornment of your rule. (Nahj al-Balagha, Letter 53)

Therefore, reducing taxes on production is in line with the principles of Islamic economics and meets the objectives of financial policy to direct liquidity in the Islamic economy, so it is an appropriate tool for tax policies to direct liquidity to investment for production in the Islamic economy.

Value Added Tax

When an economy experiences increased liquidity and inflation while urgently needing to boost the production of goods and services, it becomes necessary to eliminate or reduce production taxes and instead implement a "Value-Added Tax (VAT)" to direct existing liquidity toward investments in productive activities and reduce inflation.

"Value-added tax (VAT)" is a type of indirect consumption tax that is applied in a non-cumulative manner to all stages of private production and distribution of goods and services (Donya-e-Eqtesad, 9/16/2009, No. 1898). This means that producers, distributors, and importers of goods and services across the supply chain must pay the taxes and duties specified by this law upon purchase or acquisition, and then collect them from buyers upon sale. This cycle continues until the goods and services reach the final consumer. However, it is the end consumer who ultimately bears the VAT. Intermediate actors in the chain merely act as tax collectors for the final consumer and do not pay VAT themselves.

"Value added" refers to the increase in a product's value from the initial production stage to its completion. From an economic perspective, value added is the difference between output value and input value. As stated in the VAT law: "Value added is the difference between the value of supplied goods and services and the value of purchased or acquired goods and services within a given period." (Iran National Tax Administration, VAT Law, Chapter 1, Article 3)

Every product sold in the market undergoes gradual production by multiple manufacturers. For example, bread starts as wheat is then milled into flour, kneaded into dough, and finally baked into bread. The price of the wheat contained in each loaf increases incrementally until the bread is sold at the bakery—this increase results from the efforts of various producers at different stages. The additional value created from wheat grain to bread is called "value-added."

VAT applies to all goods and services exchanged for money domestically. However, certain goods are exempt to support disadvantaged groups. (Iran National Tax Administration, VAT Law, Chapter 1, Article 1 & Chapter 2)

VAT is a widely accepted method endorsed by most economic and tax experts, often regarded by economists as the most efficient form of taxation. Many countries use VAT as a new revenue source to increase government income. Experts consider it a stable yet flexible revenue stream for governments. (Naderi & Salatin, 2018, No. 24)

The VAT system is self-enforcing, with all taxpayers acting as tax agents, keeping collection costs low. Proper implementation optimizes resource allocation and enhances efficiency.

Economically, VAT offers numerous advantages over other tax systems, including: Encouraging investment in production, boosting exports and improving trade balance, reducing tax evasion, increasing transparency in economic transactions and promoting social and fiscal justice.

Theoretically, all taxes negatively impact production and investment. However, VAT incentivizes investment and production because, as a consumption tax, it encourages savings, raises savings rates, and facilitates long-term investment opportunities. By shifting the tax burden from production to consumption, VAT reduces the psychological disincentive of taxation on investment and production, easing pressure on income earners and entrepreneurs. Most experts agree that, compared to other taxes (e.g., income tax), VAT's negative effects on investment are significantly lower.

The permissibility of VAT can be justified by the following arguments:

A) Khums on earned profits: Value added is a form of earned profit; thus, a 20% tax (khums) may be levied on it.

B) Government tax principles: VAT falls under regulatory government taxation, and the principles of governmental taxation support its legitimacy.

C) The principle of public interest (Maslahah): VAT—which directs liquidity toward productive investment, increases output and economic growth, and mitigates excess liquidity—serves the interests of the country and Islamic society.

Thus, VAT simultaneously increases the supply of goods and services by channeling liquidity into productive investment and reduces demand for goods and services by taxing consumption and limiting liquidity for spending. Consequently, price levels and inflation decline. VAT is therefore a suitable tool for fiscal policies aimed at directing liquidity toward productive investment in an Islamic economy.

Conclusion

One of the fundamental challenges facing Iran's economy in recent decades has been the excessive growth of liquidity, which has led to numerous economic problems including devaluation of the national currency, stagnant economic growth, rising inflation and exchange rates, economic uncertainty, wealth inequality, and unfair distribution of income and wealth.

One crucial solution to address the liquidity surplus is directing funds toward productive investments through government tax policies. The Islamic government possesses broad regulatory authority and has the capacity to confront economic issues and challenges.

The Islamic government can implement tax policies to create favorable conditions for investment in productive economic sectors, encouraging individuals and legal entities to channel their excess liquidity into producing goods and services needed by society while avoiding unproductive and speculative activities.

In modern economics, taxation serves as a key instrument in fiscal policies for directing liquidity toward productive investment. The government can utilize Islamic tax mechanisms to implement such liquidity management policies.

Islamic taxes are broadly categorized into legislative taxes and governmental taxes. Governmental taxes are further divided into two types based on their objectives: revenue taxes and regulatory taxes.

Revenue taxes are imposed primarily to generate government income and cover state expenditures. However, the government can also employ revenue taxes as part of its fiscal policies to guide liquidity flows.

Regulatory taxes are designed to regulate markets and influence economic behavior. Governments can strategically use regulatory taxes to steer liquidity. By imposing regulatory taxes on unproductive economic activities—increasing transaction costs for non-productive exchanges while reducing costs for productive activities that meet societal needs—the government can redirect liquidity flows toward productive investments.

The "Capital Gains Tax" stands as one of the most significant regulatory tax tools that effectively channels liquidity into productive economic sectors. It boosts the production of essential goods and services while preventing liquidity from flooding unproductive economic activities.

"Reducing Production Taxes" serves as another regulatory tax mechanism that directs liquidity toward productive sectors. Lower production taxes increase profitability in manufacturing, creating incentives for liquidity holders to invest in productive ventures.

The "Value-Added Tax (VAT)" represents an additional regulatory instrument the government can deploy during periods of excess liquidity—as an alternative to production taxes—to redirect funds toward productive investments. VAT simultaneously increases supply by channeling liquidity into production while reducing demand through consumption taxes, ultimately leading to lower price levels and inflation control.

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