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The Impact of Implementing Value-Added Tax on the Islamic Banking Practices

Ms. Raneem AbdulAziz Abdullah Alkhayyal[1] and Dr. Rehana Parveen[2]

Abstract

The main aim of this research is to determine the impact of implementing VAT on Islamic banking practices. Prohibition of Riba (interest) and Gharar (uncertainty) are the fundamental principles of Islamic banking and key differentiators to differentiate it from conventional banking practices. It was found that Riba and Gharar are the two main hindrances for the Islamic banks operating in Saudi Arabia, as these two are not endorsed by existing Sharia principles. As a result, the Islamic banks in the country leveraged Mudarabah to invest in asset development, which is supported by Sharia principles. On the other hand, rising interest rates, influenced by VAT implementation that caused a rise in commodity prices as well, led to consumers seeking less loan support. In contrast, it increased the money deposit volume of consumers. With the development of a compliance team, the Islamic banks in the country are recommended not only to enforce the practice of Standard operation procedure (SOPs) but also to start a fee-based structure that is endorsed by Sharia principles, and it would also help banks to accumulate VAT collections through fees from customers.

Keywords: *Islamic Banking, Sharia Principles, Value-added Tax, Saudi Arabian Monetary Authority, Riba, Gharar and Takaful.*

INTRODUCTION

The Kingdom of Saudi Arabia has adopted the unified value added tax agreement of the Gulf Cooperation Council (GCC) under the Royal Decree No. (M / 51) dated 3/5/1438 (the unified agreement on value added tax). Based on the provisions of the agreement, the Kingdom issued the Value Added Tax (VAT) system as well as the implementing regulations of the VAT system. VAT is levied on all financial services in the Kingdom of Saudi Arabia, and it is paid by a taxable person. It is paid as a fee, commission or express trade discount (not implied). The term "express fee" or "express commission" means the amount to be paid for the service, whether this amount is a specific monetary value or a percentage of a certain amount. While the trade discount is a fixed amount deducted from another due amount.(Meshari,2020)

From a government's perspective, the Value-added Tax (VAT), when coupled with the basic income of varying family sizes and their consumption, has the potential to generate a considerable amount of revenue (Gale, 2020). Keeping this under consideration, this study will focus on understanding the impact of implementing VAT on Islamic banking practices, mainly focusing on the Kingdom of Saudi Arabia (KSA). The discussion here will include a brief study of the Saudi tax laws and banking system of the country. Besides these discussions, this study will also highlight the limitations and implications of this study, mentioning concluding remarks on the research and proposing suggestions as well.

MATERIALS AND METHODS

Researcher chose secondary qualitative data sources to get relevant information. Due to methodological limitation of this study, resercher did not consider collecting primary qualitative data at all. The study will adopt the course of secondary collection from different online sources, such as - Google Scholar and Emerald search engines. Specific keywords would be leveraged to bring out relevant search results in tandem with different boolean operators. The approach of a Systematic Literature Review (SLR) has been considered here to acquire the necessary information for the research. An SLR method helps in finding and synthesising previous study information in an organised and transparent manner that can be replicated, if necessary, in future (Mohamed

[1] MCL Student, College of Law Prince Sultan University. E-mail: 222421003@ psu.edu.sa

[2] Assistant Professor, College of Law, Prince Sultan University. E-mail: rparveen@psu.edu.sa

Shaffril, Samsuddin, & Abu Samah, 2021). In this context, online journals, articles, website information, books, newspapers, and magazines are considered potential materials to get information for this study.

RESULTS AND DISCUSSIONS

Sharia Compliance Challenges

Exploration of how the Introduction of VAT May Pose Challenges To Maintaining Sharia Compliance in Islamic Banking

The prime implication of implementing a value-added tax structure on the economy of a nation is to be able to generate revenue (Alavuotunki, Haapanen, & Pirttila, 2019). Keeping this under consideration, banks across countries implement VAT in their businesses. However, according to the views expressed by Gani (2020), earning interest, usury, or Riba is wholly prohibited as per Sharia principles. Going by this, it becomes clear that the implementation of VAT in the banking sector, especially in countries such as - KSA, goes against Sharia compliance.

It is a fact that Islamic banks following the Sharia principles operate with specific profit and loss principles (Abbas & Arizah, 2019). In this context, Gnangnon (2020) further opined that since the value-added tax structure is dependent on consumption patterns, hence, any consumption volatility will invariably and negatively impact revenue generation through value-added tax. This indicates the uncertain or unstable nature of VAT, especially in terms of generating revenue. According to Sharia principles, any kind of business transaction that results in uncertainty is non-compliant (Farikhin & Mulyasari, 2022). Thus, it becomes evident that implementing VAT may cause the Sharia principles to recognise the practice as Gharar, which is non-compliance with the Sharia principles as well.

Examination of Whether Certain Transactions or Financial Products Face Conflicts with Sharia Principles due to VAT Regulations

Banking Loans - Bank loans are other kinds of financial transactions that conflict with Sharia principles because of VAT regulations. Citing the example of Saudi Arabian banks, Alhussain (2020) mentioned that in the case of mortgage loans, customers pay interest to banks. This interest rate is calculated by such banks considering 220 SR annual administrative fees to be paid by the banks themselves. In contrast, VAT rates influence this final payment of administrative yearly fees paid by banks. Thus, it becomes clear that bank interests are affected by VAT regulations. Contrarily, Suzuki & Miah (2021) argued that one of the significant prohibitions of sharia principles is refraining from riba (interest) practices. Hence, bank loans are found to conflict with Sharia principles.

Financial Product Innovation and Adaptation

Investigation of how Islamic banks innovate and adapt their financial products and services in response to VAT implementation

The prime objective of Islamic banks in terms of adapting their financial products or services in response to VAT implementation is to consider the Sharia principles. For example - while preparing contracts for activities, such as - mudarabah, it is essential to consider related rates as per the existing VAT rates of the country. Contextually, citing the example of an innovative financing activity, Dewar & Hussain (2021) mentioned that Islamic banks can consider investing in another asset manufacturing process by utilising mudarabah. Hence, it becomes clear that in order to follow some of the core Sharia principles, Islamic banks need to consider integrating innovative ways to leverage their financial products differently.

Educating customers in the forms of making them understand the revised cost structure, fee structures, and payment structures in relation to VAT compliant payments is a way for Islamic banks to adapt their financial products and services in response to VAT implementation. According to Menne et al. (2023), transparency is one of the significant factors for the development of accounting models in compliance with Sharia principles. Hence, by adopting the means of remaining transparent to customers by explaining to them all the necessary financial impacts of VAT implementation, Islamic banks can navigate issues related to the implementation of VAT and adhere to Sharia principles as well.

Examination of whether new financial products are emerging as a result of VAT and how they align with Islamic banking principles

Insurance Fees - The emergence of insurance fees in KSA is considered to be one of the significant after-effects of VAT implementation in the country. As per the observation made by Hassan (2020), Takaful is a long-standing Islamic insurance system, and a Takaful operator can charge Wakalah fees for a participant's account management as well. This wakalah fee is an after-effect of the VAT implementation in the country. Moreover, a Takaful operator managing a participant's account can also invest through a Mudharabah contract, which is perfectly in sync with Islamic bank principles as well.

Customer Behaviour and Perception

Analysis of how the introduction of VAT influences customer behaviour within the Islamic banking sector

One of the most notable impacts of VAT implementation on banking customers' behaviour is concerns about their requirements for loan services. In this context, Maiti, Esson, & Vukovic (2020) opined that a high rate of interest negatively impacts the demand for credit by customers. It has been observed that without the influence of VAT, the interest rates of banks are substantially reduced (Amonovich et al., 2022). Hence, it becomes evident that within the Islamic banking sector, the implementation of VAT has caused the interest rates of banks to go up. It is also a fact that because the rate of interest is the prime factor for borrowers, they always want that to be minimal as well (Nguyen & Huy, 2023).

Exploration of Customer Perceptions of the impact of VAT on the Value And Accessibility Of Islamic Banking Services

Value of being Compliant with Sharia Principles - In context to the perception of customers concerning the implementation of VAT and its relevance to the Islamic banking sector, it is mainly observed to be negative. One of the most common reasons for this negative perception of customers related to the VAT implementation is that VAT impacts the annual administrative fee payment of Islamic banks, which, in turn, affects the interests levied on consumers' loans (Al Mustaqim, 2023). As a result, consumers find that they need to shell out more money in the form of loan repayment amounts, which creates a negative impression in their minds, as Sharia principles do not endorse riba (interests).

Regulatory Compliance and Governance

Examination of how Islamic Banks are Ensuring Regulatory Compliance with VAT Laws while Maintaining Effective Governance Structures

Developing Compliance Team - The Islamic Banks of Saudi Arabia are mostly found to have implemented the standard operating procedure of developing compliance teams at their offices. One of the critical reasons for this is the fact that a compliance team is devoted to ensuring that organisations are following the regulatory frameworks, which, in turn, will ensure effective organisational governance (Garrett & Mitchell, 2020). Hence, it becomes clear that with the existence of a compliance team, Islamic banks are able to stay on course of following VAT legislations, while this also helps strengthen the governance structure of such organisations with timely updated information on any regulator changes.

Employee Training and Development - Besides ensuring adherence to existing VAT laws and further enforcing relevant business practices, it is also essential for Islamic banks to ascertain that the governance structure of the organisations does not break apart. Contextually, Hussein (2023) opined that ensuring the governance structure of a company impacts organisational performance positively. On the other hand, it is also observed that employee training and development initiatives are equally responsible for the overall organisational effectiveness (Omar & Mahmood, 2020). Therefore, it becomes apparent that with effective employee training and development programs, Islamic banks ensure an effective governance structure. When these training and development programs are aimed at the employees in the compliance team, they further help those banks by ensuring regulatory compliance with existing VAT laws of the country.

Saudi Tax Law and Banking System

The national VAT law that is in vogue in Saudi Arabia is the National VAT Law with the Royal Decree No. M113, dated 1438/11/2 H (Sagov, 2023). However, the implementation of VAT and its associated legal structures are overall monitored and controlled by the Zatca Board of Directors vide Resolution No. 3839 with the date on 1438/12/14 H (Sagov, 2023). Zakat, Tax and Customs Authority (ZATCA) rests with the onus of registering or deregistering entities in the country that might or might not come under the consideration of VAT payments nationwide (Sagov, 2023). The VAT laws in Saudi Arabia exempts the the financial services from applying vat when the consideration payable with respect to the services by the way of implicit margin and considers applying VAT only when it is applicable, by means of explicit fee, or commission just in order to be in compliance with Sharia principles.

The Saudi Arabian Monetary Authority (SAMA) is regarded as the central bank of the country with private investment programs, holding of licenced retail banks, and specialised lending institutions (Exportgov, 2023). The banking structure of the country is headed by the governor, and under the governor, there are two vice governors, one for the investment and research wing and the other for the supervision and technology wing (Sama, 2023). The critical departments of the banking structure in the country include - the general banking control department, the general financial enforcement department, and the performance and risk department (Sama, 2023). 13 other domestic banks are operating in the country with necessary government licences (Exportgov, 2023).

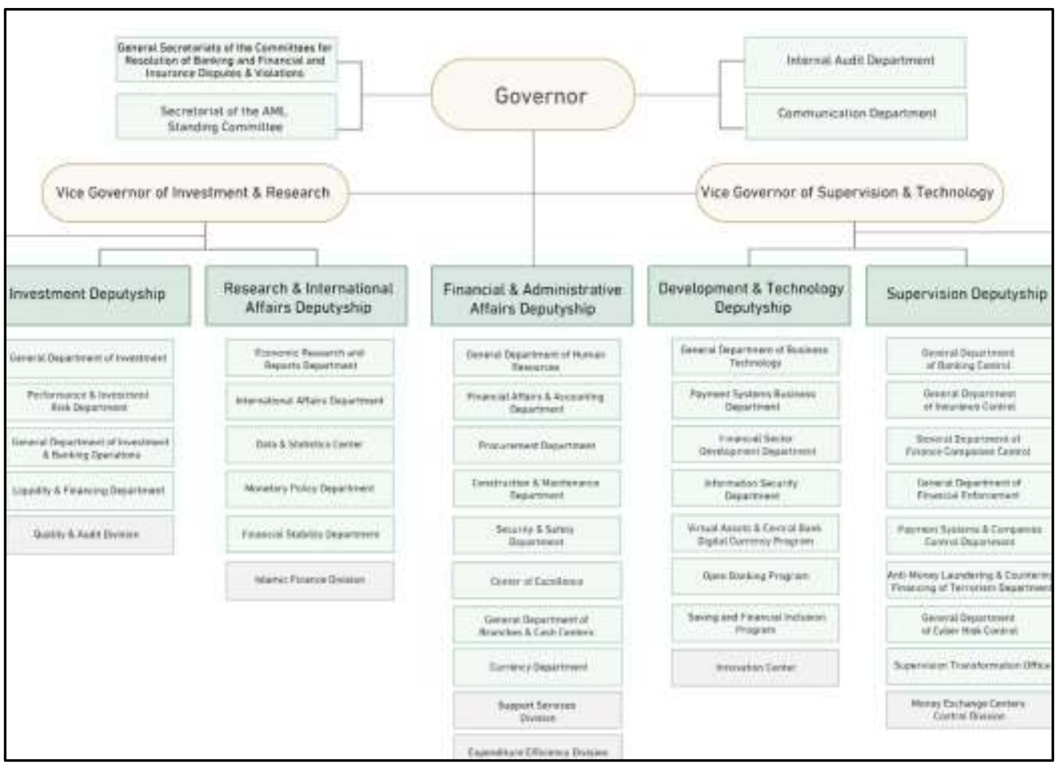

Figure 1: Banking Structure - Saudi Arabia

(Source: saudi Arabia Monetary Agency, 2023)

Investigation of the Role Of Internal Controls and Governance Mechanisms in Adapting to VAT Requirements

Documented Standard Operating Procedures - While explaining the role of internal control and governance mechanisms, Tambunan (2022) commented that a standard operating procedure (SOP) is for employees' ready reference to standard practices, and by operating, it signifies the applicability, while, procedure refers to the steps that need to be followed. Hence, for Islamic banking organisations, in order to adapt to VAT requirements, the role of a documented SOP is quite vital, as it lets the employees understand the VAT regulations while determining the inclusivity and applicability scopes and further also helps employees with proper procedural steps to complete their banking activities with regulatory compliance, as well.

Documented Transactions and Verifications - Turki et al. (2021) say transaction monitoring helps banking organisations securely monitor transaction activities, which helps uncover any potential gaps or irregularities. As a result, Islamic banks have established governance mechanisms, and where possible, it has been taken over by digital technologies as well. However, the verification part of proper applicability of VAT legislation of any transacting party solely rested with the government authorities, such as - ZATCA. As a result, it is only the governance part that the Islamic banks need to take care of to ensure they adapt to the country's latest VAT requirements.

Limitations and Implications of the Study

The observable limitation of this study is its methodological approach, which solely relies on secondary qualitative data. The study was required to consider a mixed-method approach that could have included a collection of primary qualitative data from interviews with a few Islamic bank managers in Saudi Arabia. However, the implications of this study are profound enough to let the researcher become aware of some intricate details of the Sharia principles and the Islamic banking structure, as well as their functioning. The researcher could also develop knowledge on VAT implementation, and its overall impact on the Islamic banking system in detail as well.

CONCLUSION AND SUGGESTIONS

The discussion above helps us understand the challenges that VAT implementation has brought for the Islamic banks in Saudi Arabia. The discussion above found that earning added interest (Riba) is non-compliance according to the existing Sharia principles. However, the implementation of VAT has forced Islamic banks to levy the added burden on consumers as those banks need to pay annual administration fees that include the VAT charges. Further study on this aspect revealed that bank loan services are negatively impacted because of VAT implementation, as this is also a non-compliance according to the sharia principle. The uncertainty in profit-sharing agreements, through Mudarabah, is observed to have committed Gharar as per the Sharia principle, as the implementation of GST resulted in uncertain profitability.

The research also helps conclude that Islamic banks have taken a few steps in order to comply with the existing Sharia principles while adhering to the implemented VAT regulations as well. One such way is found to be related to the usage of Mudarabah, which enables Islamic banks to invest in asset manufacturing that is permitted by the existing Sharia principles. There are certain other financial products have emerged, such as - insurance fees and Islamic bonds, because of the implementation of VAT, and Islamic banks are forced to innovate new ways to align with sharia principles. The following are the recommendations on how Islamic banking practices can align better with VAT implementation while adhering to Sharia principles in Saudi Arabia.

As Sharia principles do not endorse accumulating interests (Riba), hence, Islamic banks are suggested to consider developing fee-based structures for banking transactions or inventing new products or services which will comply with Sharia principles. However, the fee structure needs to match the existing VAT structure, which will ensure that the government also does not lose revenue.

The contract structures enforced by Islamic banks are recommended to clearly include and mention the cost implications arising out of VAT implementation. The Sharia principles firmly endorse activities of transparency.

Hence, in developing a VAT-compliant contract structure, the Islamic banks in the country will not only be able to enforce VAT but also will be able to adhere to Sharia principles.

Individual Islamic banks in the country are suggested to form and deploy an Islamic financial advisory board that will include scholars from the domain of Sharia laws. Such an Islamic financial advisory board will be better able to guide Islamic banks in terms of developing products or services that can adhere to Sharia principles better without compromising on VAT structures.

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