Comparative Economic Systems: A Brief Review

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Salman Ahmed Shaikh
Shaheed Zulfikar Ali Bhutto Institute of Science and Technology

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Islamic Economics Project

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Abstract
This paper analytically compares the theoretical foundations of major economic systems i.e. Capitalism, Socialism, Mixed economy (a hybrid of Capitalism and Socialism) and the Islamic economic system. The research identifies that lack of an ethical base, unbridled pursuit of self interest in production as well as in consumption and interest based financial and monetary system are the major problematic issues in the current economic order. Socialism promises to create heaven on earth, but takes fundamental human rights and profit motive away and in the extreme case, it gives way for an autocratic regime. The paper provides brief outline of Islamic Economics and explains that Islamic economic system is a blend of natural features present in Capitalism i.e. right to private property, private pursuit of economic interest and use of market forces etc. Along with this, Islamic economic system uses some distinct features derived through Islamic economic teachings i.e. Interest free economy, moral check on unbridled self-pursuit and provision of socio-economic justice to achieve the goals of Socialism as far as is naturally possible without denying individual freedom and profit motive.

Keywords: Economic Systems, Capitalism, Socialism, Communism, Islamic Economic System.

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1. Introduction

An economic system is a set of principles based on which an economy can run and make decisions about which goods and services to produce, how to produce and exchange them, how should the income from the production be distributed among the factor resources and what shall be the right balance between public sector and private sector and that between free market mechanism and regulation. Broadly speaking, there are following economic systems in the economic literature:

1. Capitalism
2. Socialism
3. Mixed Economy
4. Islamic Economic System

[1] Salman Ahmed Shaikh is a researcher in Islamic Economics. He is pursuing PhD in Islamic Economics at IBA, Karachi. He also serves as a Research Associate & Lecturer at IBA, Karachi. He has authored 12 papers and a book on Islamic Economics in past.

2. Capitalism

Capitalism is an economic system based on certain principles, like provision of private property rights, free market economy and allowing economic agents (consumers and producers) to purse private motives and self-interest with no or minimal government intervention.

Capitalism, unlike Islamic economic system and Socialism regards capital as a distinct factor of production worthy of a distinct factor payment i.e. interest. It supports the capitalists to benefit from wealth accumulation without having to put factor i.e. capital at similar risks that an entrepreneur faces. In this regard, interest has a huge influence on allocation of resources. It influences the basic economic decisions like what and for whom to produce.

2.1. Economic Management in Capitalism

2.1.1. What to Produce?

In an open economy and free trade environment, countries should produce the goods domestically in which they have comparative advantage. Comparative advantage principle states that if a country can produce a particular good at least opportunity cost comparatively than the rest of the world, then the country has comparative advantage in producing that good. In addition to that, the principle suggests that countries shall buy the rest of the goods from other countries if they do not have a comparative advantage in producing those goods.

2.1.2. How Much To Produce?

While producing goods in which a country has comparative advantage, the opportunity cost principle determines the level and variety of output for that country in each good it decides to produce. In an open economy and free trade, specialization and trade maximizes the aggregate combined production and hence leaves greater volume of goods for consumption and distribution in the society.

2.1.3. How to Produce?

The objective is to economize on the use of scarce resources that leads to efficient production. Countries sometimes use such input combinations which makes extensive use of factor endowments that are in abundant supply in the economy.

2.1.4. When to Produce?

Countries have to make decision about future production well in advance to meet the demands of increase in population, changes in tastes and preferences and changes in income. Countries have to produce domestically the goods in which they have comparative advantage and import the other goods to meet demand and to avoid inflation.

2.1.5. For Whom to Produce?

Resources are allocated to produce goods that can be bought in the market by people having adequate purchasing power. Purchasing power determines the size of the target market and triggers the producers to meet expected demand. Decisions about production are driven by self-benefit and profit maximization objective.

2.2. Fundamental Postulates of a Capitalistic Economy

In the following lines, very briefly, we give an account of important principles of Capitalism.

2.2.1. Right of Private Property

In a capitalist economy, people have the right to own assets and conduct any business. Within legal limits, they have the complete freedom to enter into any business activity, be it socially or morally correct or not.

2.2.2. No Government Intervention

Government does not intervene or its intervention is very minimal. Businesses are allowed to produce anything and charge any price they wish as long as they can find buyers who can afford their goods and services. A capitalist seeks maximum return for his capital and keeps all things secondary to it.

2.2.3. Freehand to Market Forces

Market forces of demand and supply are allowed to work freely. Government does not intervene in setting the prices or level of output in a model capitalistic economy. If it tries to intervene through rationing, price floors, price ceilings, quota, tariffs, taxes etc, it creates a deadweight loss and decrease in efficiency as well as in welfare.

2.2.4. Dependence on Invisible hand

It is assumed that when every person act in his/her own benefit, it will keep the economy running in an efficient way. It is assumed that social objectives will be met with people working for their own benefits. Everyone is allowed to work in his/her benefit and is not obliged to think about society, its needs and negative externalities of any private choices and actions.

2.2.5. Freedom of Choice in Production

People have outright freedom in production. A capitalist having a higher incentive to produce luxury bungalows and lower incentive to produce low cost apartments will produce luxury bungalows. All decisions are governed by private incentives and self benefit and private economic agents are not obliged to give consideration to the needs of the society. Invisible hand is supposed to bring socio-economic order by itself.

2.2.6. Freedom of Choice in Consumption

People have outright freedom to consume whichever goods they like as long as they can afford them. Consumers seek maximizing utility through increased consumption of material goods and services and do not have obligation to share their wealth with the poor masses apart from compulsory taxes. Hence, materialism, self benefit and apathy are the hallmarks of the capitalistic society.

2.3. Critical Analysis of Capitalism

Capitalism, the way it is practiced as an economic system, has largely allowed and provided legal cover to certain exploitative institutions and their operations based on free market philosophy. Such institutions have been chiefly responsible for much of distributional inequity in the world today.

Interest based financial intermediation in theory and in practice has exhibited increased concentration of wealth in the world. A system is not an end in itself; rather it is meant to serve the needs of society at large amicably.

Indeed, when we glance over statistics of poverty on one hand and rising inequality on the other, we ought to question the merits of such institutions. Indeed, even in free market philosophy, we do not allow certain institutions which bring harm to the society and individual liberty. But, yet, so far, we have turned limited attention towards critically evaluating the ever more intricate system of interest based financial intermediation in practice today.

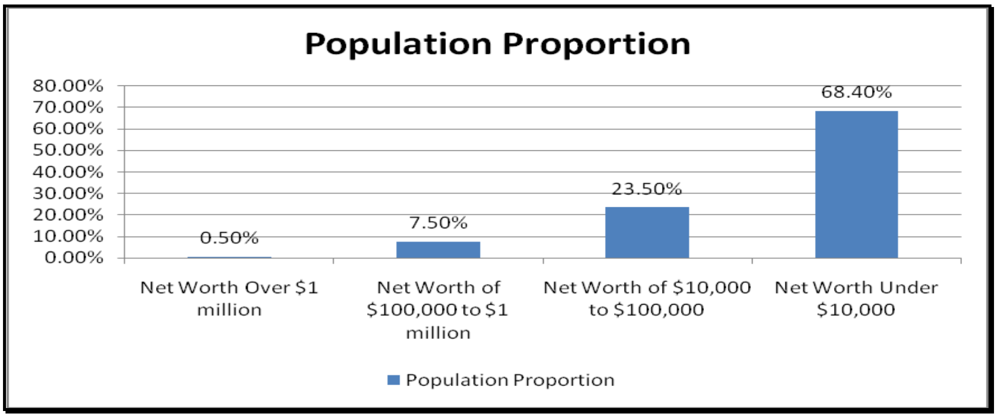
As a matter of fact, problems like poverty have persisted and even got severe in some regions in last century than in the past. Problem is not with resource scarcity, it is with distribution of resources which require an equitable and egalitarian socio-economic system. What is needed is a system that consists of institutions working towards fulfilling this objective.

Interest based financial intermediation used as a system of allocation of resources ensures a fixed return for one and variable/uncertain for another. This dichotomy in payoffs increases concentration of wealth and discourages entrepreneurial pursuits, since fixed return on wealth is ensured by the interest based system to the wealthy capitalists. No matter what is the initial distribution of wealth in society, interest based financial intermediation brings concentration of wealth eventually in every society. Indeed, inequality of wealth is not just a problem of the third world, but a fact of life in each and every country with the sophisticated interest based financial system at work.

To put matters in right perspective, income inequality even in OECD countries is at its highest level for the past half century. The average income of the richest 10% of the population is about nine times that of the poorest 10% across the OECD, up from seven times 25 years ago.

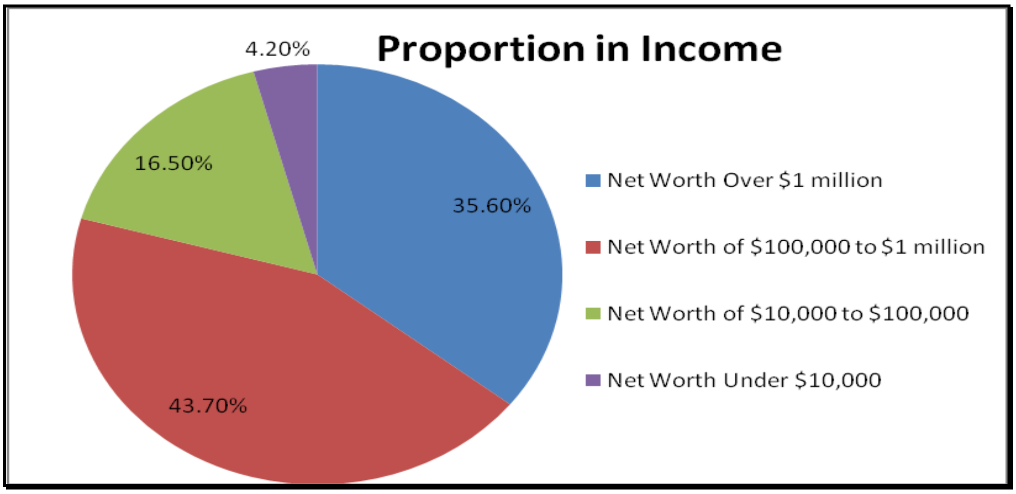
Figure 1 and 2 depict current level of inequality and concentration of wealth in the world.

Figure 1: Global Population Distribution by Income



Source: Credit Suisse Research Institute, Global Wealth Report, October 2010.

Figure 2: Global Income Distribution



Source: Credit Suisse Research Institute, Global Wealth Report, October 2010.

The disincentive to enter in entrepreneurial pursuits because of lack of willingness of capitalists to risk capital while having the opportunity to earn fixed interest income brings down investment in the economy. Decline in the potential investment in productive pursuits retard economic growth, keep unemployment high, add burden on fiscal position of government to expend on transfer payments and decrease competitiveness in the markets, resulting potentially in welfare loss and in other ills associated with market imperfections.

To get a glimpse of the negative externalities of interest based lending on poor countries, we present just a few important facts.

- Sub Saharan Africa receives $10 billion in aid but loses $14 billion in debt payments per year (Africa Action, 2008).

- Currently, Africa’s total external debt stands at $300 billion. Many African countries spend more on debt than either on health or education.

- GNP per capita in Sub-Saharan Africa is $308 while external debt per capita stands at $365.

- Nigeria borrowed around $5 billion and has paid about $16 billion, but still owes $28 billion. Regrettably, 7 million children die each year as a result of the debt crisis.

Even a key revivalist of Capitalism during Great depression, Keynes (1936, p. 377) in his monumental work “General Theory of Employment, Interest and Money” reasoned in following words:

> "Interest to-day rewards no genuine sacrifice, any more than does the rent of land. The owner of capital can obtain interest because capital is scarce, just as the owner of land can obtain rent because land is scarce. But whilst there may be intrinsic reasons for the scarcity of land, there are no intrinsic reasons for the scarcity of capital. An intrinsic reason for such scarcity, in the sense of a genuine sacrifice which could only be called forth by the offer of a reward in the shape of interest, would not exist, in the long run, except in the event of the individual propensity to consume proving to be of such a character that net saving in conditions of full employment comes to an end before capital has become sufficiently abundant. But even so, it will still be possible for communal saving through the agency of the State to be maintained at a level which will allow the growth of capital up to the point where it ceases to be scarce".

In one of his famous essay, Keynes (1932, p.358) reasoned as follows:

> "When the accumulation of wealth is no longer of high social importance, there will be great changes in the code of morals. We shall be able to rid ourselves of many of the pseudo-moral principles which have hag-ridden us for two hundred years, by which we have exalted some of the most distasteful of human qualities into the position of the highest virtues. We shall be able to afford to dare to assess the money-motive at its true value. The love of money as a possession — as distinguished from the love of money as a means to the enjoyments and realities of life — will be recognized for what it is, a somewhat disgusting morbidity, one of those semi-criminal, semi-pathological propensities which one hands over with a shudder to the specialists in mental disease ... But beware! The time for all this is not yet. For at least another hundred years we must pretend to ourselves and to everyone that fair is foul and foul is fair; for foul is useful and fair is not. Avarice and usury and precaution must be our Gods for a little longer still. For only they can lead us out of the tunnel of economic necessity into daylight."

Krugman (2009) analyzing the financial crisis of 2007-09 remarked:

> "Until the Great Depression, most economists clung to a vision of capitalism as a perfect or nearly perfect system. That vision wasn't sustainable in the face of mass unemployment, but as memories of the Depression

> faded, economists fell back in love with the old, idealized vision of an economy in which rational individuals interact in perfect markets..”

Having perfect markets leads to efficiency and economic welfare, but the institution of interest hampers potential investment by arbitrarily making capital scarce. It encourages concentration of wealth and creates a barrier in the way of use of funds in productive enterprise. Positive economics says that given an interest based investment opportunity; consider productive enterprise only if rate of return exceeds the market interest rate, but positive economics does not consider negative externalities, e.g. increased income inequality, poverty and below full employment use of real scarce resources resulting by artificially making capital scarce.

Providing an Islamic economics perspective on the institution of interest, Siddiqui (2002) explained that even in commercial loans, the borrower may suffer a loss, yet interest based lending obliges him/her to repay the principal plus compound interest. Conversely, the borrower may reap huge profits, yet the lender gets only the stipulated rate of interest which may likely turn out to be small part of the actual profits. It results in inefficient allocation of society’s resources and increases the inequality in the distribution of income and wealth as it guarantees a continuous increase in the monies lent out, mostly by the wealthy, and puts the burden of bearing the losses on entrepreneurs and through loss of jobs on the workers.

On the behavioral weaknesses of Capitalism, Chapra (1993) argued that secular societies continue to belittle the need for moral development; though all of them now profess commitment to development with justice. He emphasized that even material development with justice is not possible without moral development. The rationale for this contention is that development with justice requires an ‘efficient’ and equitable use of all resources and both ‘efficiency’ and ‘equity’ can neither be defined nor actualized without the injection of a moral dimension into economic pursuits.

2.4. Critical Analysis of Arguments in favor of Interest

2.4.1. Interest is the price of risk

It is not correct to say that lending money involves a risk. Because the lender gets interest in any condition, whereas businesses after taking operational risk either earn profit or incur a loss. In any entrepreneurial investment, the investment has to go through the entire process of a business activity that involves risk taking at each stage and any compensation on investment is strictly dependent upon the outcome of the entrepreneurial activity. Time value of money is the problem for the investor to avoid keeping his money idle and to avoid forgoing the use of money that may bring positive value to his investment. However, it does not mean that the investor can demand an arbitrary increase (or is given as the case may be) as the cost of using money without taking the entrepreneurial risk.

2.4.2. Share in the profit of the borrower

Interest is not a share in the profit of the borrower because if money is borrowed for fulfilling needs rather than for conducting business, then, there is no question of a profit. But, even if money is lent for commercial purposes, then, how one can determine that the enterprise will be profitable let alone determining the level of profits. Businesses earn profits and incur losses, but why the investor doesn't share in the losses and what sort of an effort he has put in to demand a share in profits that is fixed and confirmed irrespective of the profitability of the business.

2.4.3. Interest is a rent on money

Those things on which rent is charged are used and given back in the same existing condition like homes, cars etc, while money and other consumption goods are consumed. When we borrow money, we consume it and regenerate it. When the money is consumed, the borrower has to regenerate it and the lender without taking any risk is entitled to receive the consumed money with the interest. Can we borrow apples or mangoes on rent? We can borrow hammer but not the nails based on the above classification.

3. Socialism

3.1. Fundamental Postulates of Socialism

Marx (1867) described socialism as a specific historical phase that will displace capitalism as a precursor to communism. Socialism did not promise to make everyone equally well off in economic terms and pay everyone the same wages and replace market economy in a complete sense. However, communism did promise absolute income and social equality. Socialism was to act as a pre-cursor to Communism. Some of the well known political activists of Socialist movement were Vladimir Lenin and Joseph Stalin. Some of the important countries that tried Socialism include Russia, Hungary, Poland, Romania, Vietnam, Yugoslavia etc. The salient features of Socialism are discussed below:

3.1.1. Collective property

In a model socialist economy, there is no right to own private property for commercial undertakings. All the property collectively is in the ownership of the socialist government in the country. This means that all the business enterprises are in the collective ownership, management and control of the government.

3.1.2. Planned Economy

The government in its own wisdom solves the central problems of the economy. Decisions about production, allocation and distribution are all taken by the socialist government. All the economic planning and policy making rests with the socialist government.

3.1.3. Decisions in Collective Interest

All the decisions are made by the government in the collective interest of a socialist country. People are directed to follow the instructions of the socialist government and are not allowed to object to any decision or policy of the socialist government.

3.1.4. Reduced Income Inequality

Socialist government makes the decisions about the wages arbitrarily and the wages are forced to remain equal. Socialist government tries to maintain income equality through setting the wages and disallowing any objection or bargaining.

3.1.5. Restriction on Market forces

Market forces of demand and supply are not consulted by the government in a socialist economy. Market mechanism does not prevail and all the decisions are made by the government in its own wisdom.

3.1.6. Centralized Economy

All the decision-making authority rests with the government. No one else is given the authority to make the economic decisions even for oneself. Everyone has to follow the commands of the government and everyone is treated like an employee of the government.

3.1.7. Non-existence of Private sector

Private sector is non-existent in a socialist economy. No private economic activity is allowed. Every person has to work for the socialist government and earn wages that are set arbitrarily and are not determined on the basis of quality or nature of the work.

3.2. Critical Analysis of Socialism

On the economic criticism of Socialism, Maududi (1970) explained that Socialism in its quest to tame capitalists brought one big capitalist in the form of socialist government accredited with the responsibility to operate, manage and administer the overall economy without giving society and individuals any recourse to challenge the socialist government.

In such a case, no government, consisting of humans after all, can keep itself judiciously pursuing common goals over individual goals. Usmani (2003) reasoned that socialism kills the self motive which drives individuals to excel and be efficient.

The problem in distribution of income in Capitalism arises from an Islamic perspective with the system of interest. Land has an intrinsic value and its owners receive rent on land. Labor also earns wages for the toil and effort contributed in the production process. While laborer earns wages for work he renders and the land owner earns rent for the use of land, money cannot have a separate compensation of its own until it transforms itself as capital and take the risk of entrepreneurship along with an entrepreneur.

Toutounchian (2006) also differentiated between money and capital and reasoned that if capital is combined with labor, it produces profit, but if money alone is lent, the interest it earns is not permissible.

On the political criticism of communism, Fukuyama (1992) argued that following the collapse of the Soviet Union, liberal democracy no longer faced any serious ideological challenges and thus had proved itself to be the only sustainable and successful form of government. Marx used the phrase 'the end of pre-history' to symbolize the victory of communism over capitalism. Fukuyama claimed that capitalist liberal democracy would ultimately extend to all nations and this would be 'the end of history'.

However, as the history unfolded soon afterwards, the negative effects of ethical emptiness in Capitalism also became more prominent in contemporary economic and financial crises. Lack of an ethical base, unrestrained pursuit of self-interest in production as well as in consumption and interest based financial and monetary system are the major obstacles to an equitable distribution of income that are inherent limitations of Financial Capitalism.

Unrestrained chase of self-interest, moral relativism, incentive-led economic choices and indifference to collective responsibilities has led to engender societies where economic interests have become the solitary basis of establishing and maintaining relationships.

Hence, now it is realized that reconsideration is needed of value judgments which lead to cornering of any thoughtful consideration of the fact that regulation and oversight is necessary to control and avoid crisis in today's complex economic world which is in bad shape now in terms of rising inequality of income, wealth and limited public access to influence and benefit from policy making even in liberal, but increasingly capitalistic democracies.

4. Mixed Economy

4.1. Fundamental Postulates of Mixed Economy

Mixed economy is a compromise between capitalism and socialism. A mixed economy takes the valuable features of both. Some mixed economies can be tilted more towards socialism and some can be tilted more towards capitalism. However, most countries can be classified as mixed economies in the real world. In the following lines, few fundamental features of a mixed economy are briefly stated.

4.1.1. Coexistence of Public and Private Sector

In a mixed economy, public and private sector work in parallel to each other. Usually, the public sector is responsible to provide transport, communication, defense, currency management, utilities like telephone, water, gas, electricity etc. All the other industries are in the ownership of private sector.

4.1.2. Government Regulation and Prices

Unlike in Capitalism, government intervenes in the market to regulate prices. Governments give subsidies to encourage production of necessities and their cheap availability to the poor masses. On the other hand, high tariff rates are imposed on luxuries with inelastic demand.

4.1.3. Government Regulation and Market Imperfection

Government intervenes in industries where cartels are formed. It disallows cartels and regulates oligopoly, and monopoly. The government sometimes set a ceiling price for goods and services to put check on monopolies and reduce the burden of inflation on poor people.

4.1.4. Government Intervention and Income distribution

Government intervenes to redistribute income through progressive taxes, setting price ceilings for necessities and setting minimum wages. The government also provides tax holidays, tax credits, tax rebates and other concessions and incentives to promote a particular socioeconomic activity or class.

4.1.5. Public Sector and Social Objectives

Usually, the public sector is responsible to provide transport, communication, defense, currency management, utilities like telephone, water, gas, electricity etc. Government, if necessary, provides subsidies to public enterprises so that these enterprises do not increase their prices to cover their losses. Government sometimes bears losses to avoid public displeasure in the form of inflation.

4.1.6. Promotion of Private Sector

Even though the government intervenes in the hour of need, it still provides incentive to the private sector and a level playing field to compete with the public sector. In industries where public sector and private sector coexist, government lets the market forces work and does not crowd out the private sector.

4.1.7. Deregulation, Liberalization and Privatization

Governments in mixed economies encourage private sector to take on public sector enterprises that are not running efficiently or can be better run by the private sector. It enables the government to act as a regulator rather than as a business entity.

4.2. Critical Analysis of Mixed Economy

Though mixed economy has solved some of the problems in laissez-faire and Anarcho-Capitalism, but it still lacks an ethical foundation to foster social optimization and development at a grand scale i.e. to influence social and human development. Secondly, it has retained interest based financial system which has created many economic crises in a short span of time leading to the Great Recession of 2007-09. Therefore, much of the criticism on Capitalism holds true for mixed economy as well.

5. Islamic Economic System

First of all, Islam is not just an economic system, but, a comprehensive doctrine. A comprehensive doctrine is not just concerned with one particular aspect of human life; rather it is concerned with all aspects of human life.

As per Islam, this worldly life is a test for humans. Design of this test requires human interdependence which then requires difference in ranks, i.e. endowments, abilities etc. This consequently results in difference in wealth and incomes people have. But, then, both, the rich and poor as part of this test are going to be judged on the basis of how they each individually act on the benchmarks of thankfulness, patience, obedience and upholding ethical guidelines prescribed by their Creator for them through an inbuilt conscience and through guidance provided via sending Prophets (peace be upon them all).

Essentially, this test is not to rank people on the basis of wealth, special material achievements and their social and economic status in society. People will only be ranked and judged on the basis of discretionary actions they take in which they have choices and they will be judged taking into consideration their relative circumstances. Hence, this worldview put the focus of all human beings towards the fact that material resources they enjoy are all blessings of Allah and these are instruments for this test.

Humans are much more than utility maximizing machines. They are capable of using both material rationality and moral rationality to differentiate right from wrong and need reinforcement to adopt virtues influenced by an inner urge other than just material interests.

This inner urge can be reawakened by looking beyond utility maximization models to re-acknowledge the principal fact that humans are moral being than just an instrument for maximum material advancement for self.

The unbridled pursuit of greed also requires some external source of guidance than mere reliance on material animalistic instincts of a human soul. Religion provides the ethical check and call to balance material pursuits with attention to misery of the underprivileged people.

History of economic man is fascinating. He has used the nature's blessings to find and create new and innovative ways of maximizing utility. But, nonetheless, at all points in time, he does not feel satiated. He remains poor 'relatively' to the limitless desires and nature's limitations. The dream of being absolutely apart only remains a dream in everyone's life. But, then, everyone achieves it one day. There is one place that everyone reaches where he is not accompanied by anyone. It's his or her grave. Belief in life hereafter is the only thing that gives meaning to this world and life and this is the most important pillar of Islamic Economics.

5.1. Market Mechanism Filtered by Divine Injunctions

Trade based on voluntary exchange is beneficial as collectively we can have better and more consumption bundles at our disposal if we engage in voluntary exchange. Islam also encourages voluntary exchange.

O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent. (An-Nisa: Verse 29)

The concept of division of labor, voluntary exchange and that we could collectively have better consumption bundles at our disposal if we engage in voluntary exchange than trying to fulfill all needs by ourselves have nothing contradicting with Islam or wellbeing of a society.

In an Islamic economy, market mechanism is filtered by divine injunctions. The divine injunctions are binding, but they do not disallow market mechanism to work after following these injunctions.

All that these divine injunctions do is to regulate certain actions, provide broad guidelines and through which certain restrictions are imposed on humans for their own benefit. But beyond that, market mechanism is allowed to work and in fact regarded as a just way of organizing economic exchange in society as explained by the preceding verse.

The distinctive features which enrich the market mechanism in an Islamic economy include:

5.1.1. Guiding Preferences through Divine Injunctions

As per Islam, the tendency to seek worldly pleasures from certain goods/services and actions/behaviors is natural. The test is to nurture one's conscience and fight these tendencies to grow beyond a certain level. This test is for each person in his/her individual capacity. We cannot completely deny those tendencies. Neither Muhammad (peace be upon him) nor the pious caliphs (rta) used any means other than moral persuasion to inculcate a parallel righteous behavior alongside these natural tendencies so that they remain mere tendencies, i.e. weak enough to not influence important choices humans make in matters involving a moral issue.

Rather than complimenting humans in their animalistic instincts to keep having one-eyed focus on material well-being only, Islam inculcates piousness, kindness, cooperation and communal responsibility in humans. In some instances, Islam guides explicitly to avoid extravagance, lavishness & using certain products and services which harm a human's ethical existence and well being either individually and/or harm the society in the process.

Religion provides such meaningful conditioning which enables bringing the right balance between human aspirations and their physical limits. Religion also promises salvage from the limitedness of this worldly life in heaven which will be awarded to the most righteous people. This, in turn, provides a permanent incentive to choose righteous behavior as an end with the hope and fear of deterministic results in life hereafter.

5.1.2. Inculcating Afterlife Accountability

With the concept of afterlife accountability, Islam immensely influences intertemporal choice behavior. It helps in private economic agents (consumers, producers etc.) modifying their actions in such a way that takes into consideration externalities and also their own welfare, both in this world and afterwards. Afterlife accountability stimulate positive change in behavior in a much more comprehensive and permanent manner than any regulation or material incentive could possibly do.

5.1.3. Complimenting Material with Spiritual Rationality

Islam does not deny private property rights, private rational choices and individual-specific preferences that do not contradict Islamic injunctions. Islam enriches material rationality with spiritual rationality. It suggests some institutional changes in economic environment that alter choices for more optimal intertemporal outcome and social welfare. Islam has a very clear view on certain institutions like 'interest based lending' which has been chiefly responsible for concentration of wealth, rising inequality and even poverty and is an exploitative form of earning money. Islam by disallowing interest based earnings, exploitative forms of trade and disallowing imposition of excessive taxes from the state beyond Zakah ensures individual freedom and welfare in a much more comprehensive manner.

5.2. Market Led Economic Growth

A model Islamic economy is not necessarily a state-led or state-run economy. In fact, Islamic economic principles are very much open and favorable towards market based economy.

By enabling market economy to run competitively, an Islamic economy provides market based sustainable and lasting solutions to employment creation and improvement in living standards through effective and efficient utilization of resources.

The market competitiveness is achieved by removing from the economy the factors which lead to concentration of resources, concentration of market and underutilization of given labor and non-labor resources in the economy.

Specifically, this is achieved through two key institutions:

1. Removal of interest based financial intermediation.

2. Introducing lenient fixed rate non-discretionary wealth and income (ushr and khums) based direct taxation that has a broad base.

In an Islamic economy, the goal is not only to achieve better income distribution, but to increase the aggregate production as well. Hence, economic growth is vital.

In an Islamic economy, private investment is incentivized by the institution of Zakat which favors private investment/spending than hoarding wealth. Secondly, the Zakat rates are low and hence encourage the private investment in productive enterprise. Economic theory suggests that higher tax rates discourage entrepreneurship as they decrease the incentive to produce. Lower tax rates encourage entrepreneurship and hence increase the size of the producing sector and hence production. With the increase in production, tax revenue in value terms increases. Lower tax rates can still ensure high tax to GDP ratio.

By discontinuing interest-based financial products, people with surplus income (savers) will then have two choices, either to keep idle wealth and then pay Zakat on it or to avoid decrease in wealth by going for productive investments with the start of one's own business or by participating in the business of others through equity investments. In this way, the whole economy will gradually transform from debt-based financing to equity-based financing.

Competition makes the market more efficient than what the government intervention alone could do. Hence, an Islamic economy allows markets to function effectively by removing hurdles which exist in the form of rules and institutions that create imperfection in markets.

Furthermore, economic growth in an Islamic economy is achieved through interest free financial intermediation and fiscal incentives due to which investment, both local and foreign is expected to increase, bringing in more employment, making industries competitive and hence more responsive to their stakeholders i.e. customers and shareholders without the need for active government intervention.

5.3. Improved Income Distribution in Islamic Economy

If we study the classical and neo-classical literature on growth and development, the theories and policies based on them have felt short to improve income distribution.

Islam economics has many non-state mechanisms to ensure income redistribution without interfering with individual freedom and market mechanism; we discuss three main mechanisms below:

5.3.1. Prohibition of Interest

Interest as a system of allocation of resources ensures a fixed return for one and variable and uncertain for another. In contrast, Islam encourages equity financing in which the loss/profit would be shared. This ensures better results from the perspective of redistribution and better co-operative behavior since payoffs for all parties are linked with productive sector of the economy. Consequently, markets will not have to produce speculative surplus output just to service exorbitant amount of debt and that could stabilize business cycles.

5.3.2. Family System & Inheritance Distribution

Family system of Islam brings social capital into existence. It ensures empathy and responsibility. It brings a very lasting and durable social safety net. Islamic injunctions about how to treat orphans ensure social security for individuals with special circumstances. Furthermore, Islamic inheritance laws ensure that the wealth of the deceased is distributed widely among the members of the family of the deceased. This permanently and systematically ensures doing away with the concentration of wealth in every generation at the most micro level possible. Hence, when wealth distribution gets equitable, the income distribution too is expected to become more equitable.

5.3.3. Zakat & Infaaq

Zakat is a combination of wealth and income levy. It includes all heads of income and forms of wealth excluding only the means of production, items of personal use and value below Nisab. With a Wealth Zakat, redistribution objective is directly achieved. It reduces confinement of wealth in few hands. The flow (income) and the stock (wealth) both are taxed and hence it ensures appropriate transfer of wealth and transfer of asset ownership to the needy. If an economy is in disequilibrium and policies fail to immediately recover and boost incomes, wealth Zakat enables the distributive allocation that works independently of business cycles and help stabilize the extremes of business cycles.

5.4. Provision of Distributive Justice

Islam directs Muslims to abide by justice in all circumstances. It allows access to all people to legal courts and directs the rulers to provide justice to all the members of the society without any discrimination.

Islam by prohibiting interest eliminates one important source of distributive injustice. But, it does so in a just manner by allowing all people with capital and labor or one of these to contribute in productive enterprise and earn the rewards out of actual return on productive enterprise rather than forcing the incomes of all people to become equal artificially as espoused in Communism.

5.5. Emphasis on Productive Enterprise

Money itself has no intrinsic value and is neither a rentable asset nor a tradable commodity as per Islamic principles. If capital is combined with labor, it "could" produce profit, but if money alone is lent, the interest it earns is not permissible as per Islamic principles. Interest is neither a justifiable reward of money nor capital. Money holder/owner has to convert it in one of the other factors of production, namely 1) land with natural resource, 2) physical capital stock and 3) or become an investing entrepreneur to have any justifiable compensation out of the production process.

If people do not invest, their wealth would shrink and distributed among poor masses of the society through Zakat. If they want to avoid erosion in wealth, they are obliged to either enter in productive activities themselves or invest in such venture with their capital contribution. This will increase productive investment in the economy, bring more employment opportunities and make markets more competitive.

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