

ECONOMIC SYSTEMS

Broadly speaking there are four economic systems:

Capitalism (Market Economy)⁶.

It is the economic system based on the principle of private ownership of economic resources, which include natural resources and capital. Government control over the economic activities of the people is minimum. People, as individuals and private firms, have freedom to make choices about consumption, production and making contracts. They work for self-interest and profit. Pure capitalism where the economy is completely free of government control is not found in any country. But American economy is nearer to it. Capitalistic economy functions through a network of prices and markets. Prices act as signals for producers and consumers to act in a particular direction. Changes in prices guide them how to change their sale and purchase plans. So capitalism is also called **price system** or *market economy*.

Essential features of market economy are:

- i. private property
- ii. freedom of choice and enterprise
- iii. self interest as the dominant force
- iv. competition among producers and buyers.
- v. reliance on price system
- vi. limited role for government

An economic system refers to the laws, institutions, customs, and practices that determine how a society uses its scarce human and material resources.

Capitalistic economy is highly **efficient in production** of goods and services. It ensures fast economic growth. Self interest makes people work hard and do efforts to the maximum of their capacity and energy. A lazy person is automatically punished through decrease in his income. However, capitalistic economy is **inefficient in equitable distribution of wealth and incomes**. *It fails to limit the gap between rich and the poor and ensure social justice for all.* It ignores collective interest of the society. **Self-interest of individuals becomes selfishness.** Love for material goods pushes the consideration for fellow humans to the background. This is a serious drawback of capitalism i.e. it creates extreme inequalities in incomes of different groups of the society. On one side, some individuals pile up huge stocks of wealth while on the other, a lot of people are unable to meet their basic needs of food, shelter and clothing.

It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their interest.

Adam Smith
The Wealth of Nations (1776)

Socialism (Command Economy)

In this system the state plays the dominant role in economic matters. Means of production such as farms, factories, shops etc. are either directly owned by the government or by the govt-controlled co-operative societies (communes). Production of goods and services is entirely under govt. control. The government, through planning, decides what to produce and how to distribute incomes in the country. Pure socialism has never existed anywhere. Russia, first of all, adopted socialism in 1917 and practiced it till the end of 20th century. In initial stages when the country made rapid development many people started believing socialism as a successful and desirable economic system. But

⁶ Other name of the system is **Laissez faire** economy or free market system. It means non-intervention by govt.

ultimately, Russia, along with other countries of Eastern Europe, failed to compete with capitalistic countries of America and Western Europe in economic performance. Consequently, they changed over to mixed economy. China had also adopted socialist economy. But soon, it too, drifted away from socialism towards free market economy and allowed private sector to expand in all directions. In extreme form, socialism was called **Marxism⁷ or Communism.**

Essential features of a socialistic economy are:

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| i. state ownership of all property | i. government control over economic activities. |
| iii. central economic planning | iv. less freedom of choice for consumers. |

After World War II, the slogan of socialism became very popular in developing countries like Pakistan. Since socialism is more **efficient in distribution of wealth and incomes**, the concept had great appeal for the poorer classes of society. The basic *cause of failure* of socialism was that it ignored the strength of natural human instinct of self-interest. It is an undeniable fact that individuals make maximum efforts and use best potential talent in productive activities only when they expect direct personal gain. Working for national interest is always a secondary consideration for the majority of people. **The motive force underlying socialism i.e. working for collective uplift, is weaker than the motive force behind capitalism i.e. working for personal interest**, so socialism is comparatively **inefficient in production of goods and services**. Another important drawback of socialism is its inability in timely dealing with changes in conditions affecting demand and supply of goods. Consumers often do not get the goods of their choice. In the absence of price system, the decisions of bureaucracy about production of goods and allocation of resources are mostly irrelevant or delayed.

Mixed Economy

The system found in Pakistan is called mixed economy. This is the dominant economic system of the world today.⁸ It is mixed in the sense that it *combines the features of both capitalism and socialism*. A part of productive activities in industry, trade, energy, transport and communication is controlled by the government while private sector is very strong. In general, under mixed economies, prices of goods and services are

Prosperous society or anxious society

*During past two centuries, many societies experienced unimagined prosperity. In high-income countries, most people today can afford to buy far more than bare necessities of food, clothing, and shelter. The developing countries have also seen rise in their standards of living. But widespread prosperity has not brought economic security. The modern affluent societies are in fact **anxious society**.*

settled in open markets and allocation of resources is achieved through free market forces of demand and supply. However, the government keeps an eye over the market situation and whenever it feels the need it interferes to influence demand or supply. The government also intervenes to reduce inequalities of incomes between various classes of the society. By adopting a mixed economic system, the countries try to avoid the evils of unregulated free play of self-interest—the prime force of capitalism, as well as the inefficiencies of rigid state control over economic activities that prevail under socialism.

⁷ It was the great economist **Karl Marx** who in 19th century put forward the theory of communism and central control of the economy. His socialist vision set off a worldwide political and economic struggle that has lasted over 100 years. The guiding principle of socialism is "**From each according to his ability; to each according to his need**". He wrote the famous book '**The Capital**' in 1848.

⁸ We can say that, since the advent of 21st century, it is the only system in practice in the world.

Islamic Economic System (A blend of material and spiritual considerations)

This is a particular form of mixed economy with one fundamental difference i.e. **spiritual values and moral considerations are integrated with material objectives.** People have freedom to produce and consume goods or organize their private business just like in capitalistic free market system. But they have to remain within the limits prescribed by the Holy Quraan and Sunnah. Islamic economic system is based on the belief that everything belongs to Allah Who has provided resources on earth for use by humanity as a whole.⁹ Man has been permitted to avail of all material things just like a *trustee* and not as the absolute owner. **All forms of economic exploitation of man by man are denounced by Islam.** Feudalism and unearned incomes are condemned. Basic necessities are assured for all and concentration of wealth is considered an undesirable situation. The government has the right to interfere in economic matters in the larger interest of the society. At the same time people retain a lot of freedom in economic decision making about earning and spending of their incomes. In brief, **Islamic economic system is a 'govt.-regulated free economy'.** Complete Islamic economic system is not present anywhere. However, Pakistan, Saudi Arabia, Iran and Sudan have partially introduced some principles of Islamic economic system e.g. interest free modes of banking and finance.¹⁰

Important features of an Islamic economic system are:

- *teachings of Qur'an and Sunnah* to serve as guiding force for all economic activities.
- existence of *private sector* and ownership of private property.
- a *system of prices and markets*.
- *freedom of choice* in production and consumption matters.
- *Zakat*: collection and distribution by state.
- *interest-free economy*.¹¹ (instead, the principle of Musharkah and Muzarbah applied in business)
- *moral aspect* is integral part of all economic decisions.
- *state welfare policies* and programs for low-income groups to ensure provision of basic needs for every one.
- *state responsibility* to eliminate all forms of exploitation of man by man such as feudalism and reduce inequalities of income and wealth.

No country of the world is following a pure capitalistic, socialistic or Islamic economic system. All have mixed economies.

⁹ 'We have produced for you all whatever is available on earth.'— Al-Quraan—(Sura Baqra—verse 29)

¹⁰ Islamic economic system differs from capitalism and socialism on three basic points.

(i) **Accountability after death:** The starting point of Islamic system is the belief in life after death and that every human action in this world will be either rewarded or punished in the life hereafter.

(ii) **Ownership:** In other systems, ownership of resources and goods belongs to people—individually in capitalism and collectively in socialism. But in Islam, people cannot claim absolute ownership. Their ownership is a kind of trusteeship. They can keep property under their control and use material things within the moral boundaries prescribed by the Quraan.

(iii) **Moral values:** The motives of self-interest and personal gain work under the shadow of moral values of Islam. In some cases, moral values and social service become the prime motive force. People, individually and collectively, are expected to observe Islamic moral code. Important moral values related to human activities are Taqva, Adl, Ihsan, Brotherhood, Human equality and Cooperation.

¹¹ **Musharkah, Mudarbah and Murabaha:** These modes of business are used as an alternative to interest bearing practices. In Musharkah two or more persons become partners by sharing capital in some proportion. In Mudarbah two persons become business partners in the sense that one person provides the capital and the other provides the labour. (Musharkah is an Arabic word meaning partnership. In Urdu it is written as Musharkat. The Arabic word Mudarbah is written as Muzarbat in Urdu)

CENTRAL PROBLEMS OF AN ECONOMY

The whole study of modern economics is ultimately the explanation of three economic activities; *production, consumption, and distribution* of goods or services. These activities give rise to three basic issues; *What to produce, How to produce, For whom to produce*. Regardless of its economic system, every society has to find answers to these three¹² basic questions.

1. What to produce (Allocation of Resource)

What commodities, and in what quantity each one, shall be produced? At first glance, the answer may seem simple and obvious i.e. we need food and clothing, so we must produce these goods. But in reality it is a difficult question. Resources at people's disposal are not unlimited. So producing more of one thing requires producing less of something else. For example, more food could mean less clothing as land is shifted from cotton to wheat production. The realization of this fact compels us to make hard choices about "what to produce" and to decide what combination of goods would be the most desirable. Different ways are available for choosing what to produce with scarce resources.¹³

2. How to produce (Choosing Techniques of Production)

How shall goods and services be produced? One good or service may be produced using different methods of production and applying different combinations of resources. For example electricity can be produced by using coal or oil. Similarly wheat can be transported by trucks or trains and chairs can be made out of wood or plastic. Some methods of production are more efficient and profitable than others. In a free market economy or mixed economy, where profit is the prime motive, only that method of production or technology is used which ensures highest profit. Under government controlled economy i.e. socialism, govt. administrators decide the question, 'how to produce'. Under Islamic system, private firms will be free to use any method they think can bring more profits, provided it is not against the interests of the society and does not violate basic Islamic teachings. [For example, to increase their profits, the firms cannot use donkey's leather to make ladies' purses. Similarly a chemical firm cannot use a method which spreads poisonous waste in the surroundings]

3. For whom to produce (Distribution of national income among people)

Who shall get and consume the goods and services produced? Goods are not produced free and can never be available to every one in as much quantity as he would like to have at zero price. So a difficult question arises; "What share of national production various members of society should get?" The answer to this question is linked to incomes which people receive. In a free economy, people get their incomes in the form of rent, interest, wages and profits. A person getting higher income can buy more goods and services for consumption. For example, wages received by a person decide his share in national

¹² Some writers prefer to explain the problem as four or five basic questions. They split the question of 'how' to include 'where' and 'when'

¹³ **Resource Allocation.** Economists refer to the problem of choosing different ways for using scarce resources of land, labour and capital as 'resource allocation'

income. And the rates of wages etc. are determined by the forces of demand and supply in the open market. The free market system rewards people according to the market value of their work.¹⁴ Command (socialist) economies resolve this problem by letting the govt. decide how much each worker will be paid. Mixed economies and Islamic states will adopt a middle course. Free market forces will decide the incomes of different people. But if too much inequality of income and wealth has arisen, the government can adopt corrective measures.

In summary, we can say that the answers to the above mentioned basic questions depend upon the system, which a society follows.

A look at the basic questions also gives us a sense of *what is economics about* i.e. they tell us about the *scope of economics*.

(For detailed discussion of economic systems, see Part - II of the book)

¹⁴ Film stars and sports stars get huge pay cheques because of their market value, otherwise they do not work harder than other labourers. So here the question arises; is this market-based system of distributing incomes fair? Compared to socialism, market system is very efficient. Under this system every body works for his private profit, and the market quickly responds to people's wants and efforts. But at the same time, it favours those who have already more wealth and causes inequalities of income to increase.