A Comparative Study of the Major Economic Systems in the aftermath of the Great Recession

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Abstract
This paper compares the fundamental postulates of major economic systems i.e. Capitalism, Socialism, Mixed economy (a hybrid of Capitalism and Socialism) and the Islamic economic system. It identifies through a review of theoretical economics the structural problems that lie in the current economic order. Poverty and Inequality have increased in last two decades and the millennium development goals are still far from achieved. The research identifies that lack of an ethical foundation, unbridled pursuit of self interest in production as well as in consumption, interest based financial ad monetary system are the major problematic issues in Capitalism against which mixed economy has also shown limited effectiveness. Socialism promises to create heaven on earth, but takes fundamental human rights and profit motive away and in the extreme case give way for an autocratic or totalitarian regime. Islamic economic system in its true sense is not present in any country. It is a blend of natural features present in Capitalism i.e. right to private property, private pursuit of economic interest, use of market forces etc used along with 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, Interest free economy, Interest free finance, Capitalism, Socialism, Communism, Islamic Economic System, Theoretical economics, Marxism.*

1. <u>Introduction</u>

It is a tragedy that humans are regarded as subservient to systems. Modern thinkers make humans seem mere tools and not able to influence systems. Systems did not get functional by themselves. It is not like that systems were running on their own and humans became part of systems. In post modernism literature, Marcuse (1964) has described this phenomenon as 'One Dimensional Man' in his book with the same title.

Humans indeed made systems and who can change them for better. Systems do not need to be modified or altered if they are stable and providing the benefits for which they are created and made to operate. But, if they are not providing the desired results, they can and should be altered to provide the desired results.

Indeed, when one sees poor, ill fed, malnourished children on one side and observe multinationals investing millions in ad campaigns to market durables and luxuries which most cannot afford, it provides a strong enough reason to revisit the systems.

Economists thought depression is a thing of the past up until now when the unprecedented financial crisis of 2007-08 has reached a scale which nobody forecasted. There is already debate on replacement of Breton woods and search for alternates.

This is a critical time when economists can offer after thorough research untried remedies for getting out of the financial crisis and provide holistic, stable, robust, equitable yet a practicable system.

In this backdrop, this study takes an analytical approach to revisit the fundamental postulates of major economic systems and identify the structural issues which need to be addressed in the pursuit of economical revival in the short run and furtherance of millennium development goals in the long run.

2. Central Problems of an Economy

The central problems of an economy revolve around one of the most important aspects of human life that our resources are scarce to fulfill our unlimited wants. The scarcity of resources creates a dilemma for economic managers who have to make a choice from among the set of alternatives. To make the economic choices, economists and economic managers confront following questions:

2.1 What to Produce?

Resources are scarce as compared to unlimited wants. Not all of the goods and services can be produced with the given set of human, physical, technical resources and capital. Countries have to choose between a long list of goods and services the particular goods and services that they want to produce given the demand, social and economic needs and limited resources.

2.2 How Much To Produce?

Even if a country produces a particular set of goods, it cannot produce them in unlimited quantities. If all the resources are devoted for producing only one good or service, no resources will be left to produce other goods and services.

2.3 How to Produce?

Globalization has stimulated the competition and the need to seek cheap methods, location and resources to minimize cost. Countries have to decide how best they can achieve the level of production with the limited amount of resources they have.

2.4 When to Produce?

Predicting demand changes is important for survival. All the countries and corporations want to sell but they also do not want to end up with excess supply and lesser returns. With increase in population, countries have to increase their production of all goods and services to avoid inflation.

2.5 For Whom to Produce?

Not all the people can be accommodated in their desires due to scarcity of resources. The choice of production in goods and services, level of production and method of production is made with the specific needs of the market.

3. Economic Systems

An economic system is a set of principles on which an economy can run and make decisions about the central problems it faces in the form of scarcity of resources and unlimited wants.

There are following economic systems that the countries adopt in running their economies.

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

4. Capitalism

Capitalism, unlike Islamic economic system and Socialism regards capital as an individual factor of production creditable of 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. It shifts the break even line further away from the entrepreneur and crowds out entrepreneurs who cannot afford to keep feeding capitalists. 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.

Capital is needed for technological advancements. It is needed for production and consumption and for governments to expend on development. It is even needed to influence policies by winning elections after expensive election campaigns. There would not have been many complexities if markets were efficient and income and wealth distribution fair. But, the world we live in has never and perhaps never will have perfect equality and perfect competition.

Interest serves capitalists and allows them to accumulate wealth. This is evident from the empirical statistics on inequality in income and wealth in second half of the 20th century when monetary capitalism with institutional support expanded in an increasingly integrated and global economy.

In 2001, there were 1,100 million people living in poverty. But in Sub-Saharan Africa, the number of people in extreme poverty rose to 313 million. (Source: World Development Indicators 2005)

Hence, much of the technological advancements, increase in production and better standards of living with increase in earning opportunities and welfare expenditure has occurred in that part of the world which was able to accumulate capital effectively than the rest of the world in pre-capitalistic and early capitalistic eras.

4.1 Economic Management in Capitalism

4.1.1 What to Produce?

Countries produce the goods domestically in which they have comparative advantage and trade the other goods from other countries in which they do not have a comparative advantage.

4.1.2 How Much To Produce?

Therefore, countries have to trade-off one good for another between the set of goods that they can produce. The opportunity cost of each good for each country determines the level and variety of output for that country.

4.1.3 How to Produce?

Cost minimization gives a country comparative advantage in gaining access to other markets and countries. Decrease in price increases demand and revenue (up to a limit). Cost minimization enables a country to increase its production of all goods and services with the same existing amount of resources.

4.1.4 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.

4.1.5 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, current and future income prospects determine 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.

4.2 Fundamental Postulates of a Capitalistic Economy

Capitalism is a natural economic system unlike socialism. That is why; it has fared well throughout history, practiced most widely and has outmoded Socialism. Most Socialist countries have adopted features of Capitalism and the growth of China since 1980s after it made a compromise between Capitalism and Socialism and adopted some of the important Capitalistic values further strengthen the case to use Capitalism (though modified to suit the needs of a particular country) over outright Socialism.

4.2.1 Right of Private Property

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

4.2.2 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. Therefore, a capitalist seeks maximum return for his capital and keeps all things secondary to it.

4.2.3 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.

4.2.4 Dependence on Invisible hand

It is assumed that every person acting in his/her own benefit will keep the economy running in an efficient way. Everyone is allowed to work in his/her benefit and is not obliged to think about society and its needs. It is assumed that social objectives will be met with people working for their own benefits.

4.2.5 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 incentives and self benefit and no consideration is given to the needs of the society. Invisible hand is supposed to bring socio-economic order.

4.2.6 Freedom of Choice in Consumption

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

4.3 Critical Analysis of Capitalism

Interest is prohibited in all monotheist religions (See Exodus 22:25, Leviticus 25:35-36, Deuteronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12). However, interest is pervasive in capitalism.

Even among secular literature, one finds criticism on interest. Aristotle (384-322 BC) in his book “Politics” criticized interest in following words “Of all modes of getting wealth, this is the most unnatural". In value neutral economics too, we find criticism on interest. Keynes (1936, p. 377) in his monumental work “General Theory of Income, 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 recognised 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 [September 02, 2009] in his New York Times article titled “How Did Economists Get It So Wrong?” analyzed the current financial crisis in following words:

> “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, this time gussied up with fancy equations… Unfortunately, this romanticized and sanitized vision of the economy led most economists to ignore all the things that can go wrong. They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets — especially financial markets — that can cause the economy’s operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don’t believe in regulation.
>
> … So here’s what I think economists have to do. First, they have to face up to the inconvenient reality that financial markets fall far short of perfection, that they are subject to extraordinary delusions and the madness of crowds.”

Sameulson (1948) in his criticism on extra reliance on market forces stated that market forces will only lead to ‘starving couples’ to malnourished children who grow up to produce malnourished children, to perpetuation of Lorenz curves of great inequality of income and wealth for generations or forever.

Among Muslim Economists, Siddiqui (2002) criticized interest stating 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.

Chapra (1993) viewed secular societies continuing 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.

He outlined unrealistic assumptions in capitalism which will not make invisible hand alone to address the issues of equity:

1. Harmony between individual and social interest e.g. unscrupulous consumption and imposing externalities on society.

2. Individual preferences reflect social priorities e.g. precedence of self interest over social priorities.

3. Equal distribution i.e. unequal distribution of income gives more weight to resourceful class to influence allocation of resources to their desired use.

4. Prices reflect urgency of wants i.e. no mechanism to differentiate between necessities and not so necessities, e.g. want satisfaction of few does not mean need satisfaction of all especially when resources are scarce and can only be used for alternative uses.

5. Perfect Market i.e. price mechanism can have a minimum impact on socially desirable allocation of resources; it works when there is perfect competition. But, market imperfections even dilute this little influence that price mechanism could have on socially desirable resource allocation when prices are completely out of line of real out-of-pocket costs.

6. Social Darwinism i.e. richest are the fittest to survive by the sheer weight of their purchasing power to influence the resource allocation.

Theory of Comparative Advantage states that resources should be allocated to the efficient sectors of the economy. If U.S.A has a comparative advantage in producing cars and if Pakistan has a comparative advantage in producing wheat; then, Pakistan should allocate its resources on producing wheat and U.S.A should allocate its resources to produce cars. Both Pakistan and U.S.A can gain from exchange and specialization.

But this will only work when the trade is fair and when both countries do actually allocate their resources to their efficient sectors. Instead what happens is that developed countries have absolute advantage in producing most goods over developing countries. Developed countries allocate their resources in producing goods that they can produce most efficiently and use the proceeds from sale to provide subsidies to their inefficient sectors and virtually paralyze the developing economies by depriving them of their chance of gaining through exchange and specialization.

The export subsidies provided by developed countries to their inefficient sectors enable the inefficient sector to become efficient artificially and crowd out the developing countries by overproducing and then dumping these goods in the third world countries. If the supply exceeds demand, developed countries have not been reluctant to dump their production in sea if they can't do it in the developing countries!

By providing export subsidies to their inefficient sectors, developed countries create distortions in trade and misappropriations in resource allocation. The export subsidies paid by the developed countries to their inefficient agriculture sector are funded through the proceeds of exports. Therefore, effectively these subsidies are paid by the developing countries. Developed countries charge huge premium for value addition that is not in line with their out-of-pocket costs. The difference is especially huge in information technology products, software and pharmaceuticals. Once software or medicine is made, the capacity is virtually unlimited. Unlimited copies can be sold provided there is enough demand. Cost per unit is spread over larger output. At higher levels of output, marginal cost is negligible in these products.

Therefore, developing countries are denied gains from comparative advantage in agriculture through export subsidies provided by developed countries to their comparatively inefficient agriculture sector. Subsidies of $350 billion a year to agricultural producers in OECD countries are a barrier to developing country exports (Source: World Development Indicators 2005). This creates unemployment and poverty in the developing economy. Eventually, a developing country will have to submit itself before the international financial institutions that are able to exert extraordinary influence -not limited to economic but also political- in the developing country. Therefore, the role of IMF, World Bank, WTO and the adaptation of Structural Adjustment Program and Free-Float exchange rate systems are all interrelated in their objectives to maintain the status quo of supremacy of developed world over developing countries.

Developing countries are given some extra time to restructure themselves than the developed countries. But, the time limit is very short for an economy to restructure itself. Small economies with little population are able to restructure themselves like East Asian countries. But, the tropical countries with agrarian economies and huge population are not able to restructure themselves so quickly.

Industrial revolution came in mid 18^{th} century. Capitalism as we know had its roots in as early as in the 15th century. Even then, the change from agrarian based economy to industrialized economy was not rapid. Similarly, information revolution in the last two decades needed a maturing industrial revolution as a preset. Therefore, if it took centuries for Europe to restructure their economies, how can developing countries are expected to restructure themselves in less than a decade!

The shallowness of the WTO is evident from the fact that it has not addressed following key areas in international trade and politics.

- Oil trade is completely out of WTO influence
- No agreement on smuggling
- No agreement on anti-money laundering
- Drug trafficking is out of WTO influence

4.3.1 Need for Redefining Priorities

After providing exemplary standard of living to their citizens, developed countries embarked upon providing such luxury to animals as well. But, humans should have more value than animals! This assertion will not look odd when they will have to trade off between their citizens and engendered species! Using TBT (Technical Barriers to Trade), SPS (Sanitary and Phyto Sanitary) measures, environmental excuses and safety measures for saving extinct species while the developed world is responsible for most of the world's pollution and climatic change is completely baseless. High-income countries account for half the world's Co_2 emissions (Source: Carbon Dioxide Information Analysis Center data).

Less is better if it is distributed fairly equally than more wealth distributed unequally. Efficiency measures need to include social objectives. Priorities need to be set right and there should be a worldwide consensus on the following issues:

4.3.2 *Growth Vs Development*

Growth is important but development is pivotal. Growth that does not result in development is less desirable. Reducing inequality is more important than increasing the growth rate.

4.3.4 ***Profit Optimization Vs Social Optimization***

Social Optimization is more important than Profit Optimization. Achievement of social optimization if not possible through the private sector, it must be brought about through government intervention.

4.3.5 What goes around comes around!

Reducing trade barriers is said to benefit consumers as they will have range of competitive products at their disposal. But, consumers earn through factor payments that come through producers. If domestic producers will be crowded out of the market in a no-trade barrier regime; then, consumers will lose jobs and their purchasing power will decrease subsequently. Therefore, in the long run, it merely becomes a zero sum game.

Summarily, as a capitalist, one even with the knowledge that weapons one sells will kill millions in Africa, would not bother as that what he does for profits as a capitalist. Though, one may favor democracy, but if nationalistic interests are better served by dictators, one will bear them as a head of state of a country in a developed world. Though, one may favor progressive taxation in principle, but if indirect taxes can pay back loans smoothly, one my direct imposition of indirect taxes in developing countries as a chairman of IMF or World Bank.

4.4 **Critical Analysis of Arguments in favor of Interest**

4.1 **Interest is the price of risk**

It is not right 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 risk.

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 profit and incur losses, why the investor doesn’t share in the loss and what sort of an effort he has put in to demand a profit that is fixed and confirmed irrespective of the profitability of the business.

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.

5. Socialism

5.1 Fundamental Postulates of Socialism

Some of the pioneer and well known social thinkers include Robert Owen, Charles Fourier, Pierre-Joseph Proudhon, Louis Blanc, Charles Hall and Saint-Simon. Socialism was to act as a pre-cursor to Communism. Karl Marx described socialism as a specific historical phase that will displace capitalism as a precursor to communism. Socialism does not promise to make everyone equal and pay everyone the same wages and replace market economy in a complete sense. However, communism does promise income and social equality. Some of the well known social leaders include 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:

5.1.1 Collective property

In a socialist economy, there is no right to own private property. 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.

5.1.2 Planned Economy

The government in its own wisdom solves the central problems of the economy. Decisions like what to produce? how to produce? When to produce? for whom to produce? and how much to produce? are all taken by the government. All the economic planning and policy making rests with the government.

5.1.3 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 government and are not allowed to object to any decision or policy of the socialist government.

5.1.4 Reduced Income Inequality

Government makes the decisions about the wages arbitrarily. The wages are forced to remain in parity in all fields. Government tries to keep income equality through setting the wages and disallowing any objection or bargaining.

5.1.5 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.

5.1.6 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.

5.1.7 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 government and earn wages that are set arbitrarily and are not determined on the basis of quality or nature of the work.

5.2 Critical Analysis of Socialism

On the economic criticism of Socialism, Maududi (1970) analyzed that socialism in its quest to tame capitalists brought one big capitalist in the form of government i.e. communist party accredited with the responsibility to operate, manage and administer the overall economy without giving society and individuals any recourse to challenge the government. In such a case, no government, consisting of human after all can keep itself judiciously pursuing common goals than individual goals. Usmani (2003) reasoned that socialism kills the self motive which drives individuals to excel and be efficient.

The predictions of Marx about Capitalism also did not materialize and his Theory of Surplus Value was also criticized later on. The problem in distribution of income in Capitalism from an Islamic perspective was only with interest. Land has an intrinsic value and its owners receive rent on land. Labor also earns wages even when the entrepreneur suffers loss. Value of production i.e. prices of goods is not always sufficient to create surplus after paying wages, rent and interest. While laborer earns wages for work it 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.

M :{(1) L=100%; (2) V>1; (3) MC=0; (4) d=0; (5) ó=0; (6) R=r}
K :{(1) L<100%; (2) V=1; (3) MC>0; (4) d>0; (5) ó>0; (6) R=ñ}

Where: L= liquidity; V= velocity; MC= marginal cost; d= depreciation
R = return; ó = risk; r= rate of interest; and ñ = rate of profit

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'.

6. Mixed Economy

6.1 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.

6.1.1 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.

6.1.2 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.

6.1.3 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.

6.1.4 Government Intervention and Income distribution

Government intervenes to redistribute income through progressive taxes, setting ceiling prices 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 social activity, economic activity or socioeconomic class.

6.1.5 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 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.

6.1.6 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.

6.1.7 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 a business entity.

6.2 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 free financial system which has created at least two havocs i.e. one in East Asia in 1990s and the Great Recession since 2007 in the short two decade long post-soviet union era. Therefore, much of the criticism that is made on Capitalism holds true for Mixed economy as well.

7. Islamic Economic System

7.1 Fundamental Postulates of Islamic Economic System

Islamic economic system in its true sense is not present in any country. However, its salient features and important values can be discussed. It is a blend of natural features present in Capitalism i.e. right to private property, private pursuit of economic interest, use of market forces etc used along with 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 incentives. Some of the distinct features of an Islamic economic system are discussed below:

7.1.1 Equitable distribution of Income

Islam through the system of Zakah reduces the Gap between the rich and poor. It is a progressive system of taxation. It levies a special tax on cash, cash equivalents and capital in excess of need that makes sure that the money circulates and is used in the productive activities. Since it is not only a state obligation but a religious obligation, it will not result in tax evasion. It reduces confinement of wealth in few hands.

7.1.2 Prohibition of Interest

Islam prohibits interest to relieve the society from the exploitation of capitalist. It encourages entrepreneurship and trade. It relieves the society from the disincentive to produce in an interest-based system. It encourages circulation of wealth.

7.1.3 Spending in the way of Allah

Islam directs Muslims to pay Zakah. Besides, it encourages people towards charity to help poor and gain benefit in the hereafter. Only with the knowledge of life after death and the belief in God, can one decide to act morally as an end in itself and not merely as means to a material end. Moral act in Islam also is a means to an end i.e. to achieve eternal success and blessings of God. But, it is not a material end confined to this life only. In this way, the utilitarian mind is also satisfied as happiness is a relative term not achieved only by material things. The fact that moral actions even if they are not rewarded in this world will be rewarded in life hereafter satisfies the utilitarian mind.

7.1.4 Protection of Rights

Islam unlike socialism does not put restriction on private property. It allows people to own assets, conduct trade and business as long as they avoid any immoral act.

7.1.5 Provision of 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.

7.1.6 Equality of Opportunities

Islam by prohibiting interest gives the underprivileged people chance to earn their living. A rich man in a capitalist economy will remain rich by investing his wealth to earn interest. Islam by prohibiting interest eliminates the economic and social divide between the rich and the poor. Yet it does so in a justifiable manner rather than forcing the incomes of all people to become equal artificially as in socialism.

7.1.7 No Gender and Ethnic Discrimination

In Islam, all the persons black or white, male or female are entitled to an equal amount of remuneration for an equal quality and quantity of work. Whereas, even in capitalist countries, there is huge income inequality between the incomes of blacks and whites and males and females.

7.1.8 Dealing with Scarcity of Capital in an Islamic Economy

Business cycles are a reality. Infact, as per Islam, they must exist as this world is a place for test and this test requires some people to be privileged and some to be deprived. The deprived and privileged are both tested for patience and thankfulness to Allah and how they take care of society and its needs. But, interest as a system of allocation of resources ensures a fixed return to one and variable/uncertain for another. That is why, business cycles affect borrowers negatively. Hence, leveraged companies thrive in upturns, but lose in downturns. Equity financing ensures justice.

Interest makes capital scarce, brings oligopoly in capital goods industries and monopolistic competition in consumer goods industries i.e. market imperfections. Market imperfections lead to mismatch between supply and demand, hence create downturns every now and then in economy. This downturn leads to monetary easing to increase Aggregate Demand, but the market remains imperfect even then because capital is still scarce with interest and no wealth tax (more prominently in developing countries with indirect taxes greater than direct taxes). If it is followed by cost-push inflation, it gives rise to Stagflation eventually. In Stagflation, monetary economics fail and further exacerbate the situation with output decreasing and capital made scarcer with increase in interest rates. Inflation can be better checked through supply chain management and removing market imperfections complimented by progressive taxation.

Business Cycles will continue to exist as they are natural, but the loss/profit would be shared. Therefore, markets will not produce speculative surplus output and that will stabilize business cycles.

Stagflation (Inflation rises and GDP growth decreases) defies both Okun's law (If GDP increases by 3%; unemployment decreases by 1%) and Taylor's Rule [Monetary tightening by more than unity (i.e. >1% increase in interest rates) for a unit % increase in inflation (i.e. 1%)].

Furthermore, Inflation in U.S is down, but not entirely due to monetary policy. Food prices are down due to subsidies and energy needs of U.S are also met not entirely using market (i.e. due to political factors and influence in resource rich countries to procure resources cheaply). Even if interest rates were decreased to below 2% in U.S, Inflation has not risen. If inflation is supposed to have a link with nominal interest rates, it should have it in both ways. Even with monetary easing, inflation has not risen in U.S.

Economists especially from Chicago School analyzing Great Depression criticize Central Bank for having not adopted monetary easing and thereby worsening the sentiments. Great Depression, as we all know, occurred after Stock Market Crash. In the 'Great Recession' today, Central bank in U.S is not adopting tight monetary policy because inflation is tackled through non-market forces (Subsidies and Political influence in resource rich countries to meet demand at affordable prices) because U.S did not have that financial capacity nor the political influence at the time of Great Depression unlike today. But, this monetary easing has still not caused private investment and private sector borrowing to increase and the huge trade and fiscal deficit of U.S is still not causing the crowd out effect and same is the case in Pakistan after the reduction in policy rates.

These sentiments, as Keynes said, can only be revived by Public investment either through increasing government expenditure in public sector enterprises or by providing subsidies to private sector enterprises. No matter how hard one tries to deny it, but when one considers the bail-out package for financial sector as well as for the producing sector in U.S, one cannot say government has no role to play in capitalism.

In an Islamic economy, Interest will be abolished by a legal decree complimented by an imposition of broad based wealth tax (Zakah). An imposition of wealth tax (Zakah) would ensure that loanable funds increase even when there is no interest. The loanable funds would be invested in equity modes of financing including Mudarabah and Musharaka. Investments in equity will be exempted from wealth tax. This would ensure that investors get a minimum return i.e. tax savings plus income on their equity investments. This tax exemption would also ensure the availability and supply of loanable funds.

Income only bonds can be introduced. These bonds need to be serviced provided there is income. The service payments on these bonds will be tax deductible. Tax deductible feature would benefit issuer and the compulsory servicing of bond in case of income would benefit investors to invest in blue chip companies. Companies which are not in the ranks of blue chip companies would issue convertible income only bonds. Exemption of investment in income bonds would also ensure the availability and supply of loanable funds in income bonds market.

Dividends will allowed to be tax deductible; thereby, benefiting the corporations to benefit from tax advantage and increase the frequency of dividend payments and make it a regular feature. This will further boost and compliment the availability of loanable funds.

By abolishing interest by way of a legal decree, primary market activities in equity markets will increase since corporations will no longer be able to generate finance through interest based debt. Therefore, increase in listed companies will expand the market and diversify trading opportunities for investors.

7.2 Critical Analysis of Islamic Economic System

Nevertheless, much of criticism on interest, capitalism and its ideals has been made without reference to developments in contemporary systems and institutions. In proposing alternative to Capitalism, an idealistic approach is adopted.

Pal (2006) thus criticized the traditional approach of comparing Islamic ideals with practiced capitalism. He stated that systems cannot be analyzed judicially with taking ideals of one and the practice of the other.

Conclusions

This paper evaluated the basic premises of major economic systems i.e. Capitalism, Socialism, Mixed economy (a hybrid of Capitalism and Socialism) and the Islamic economic system. It identified through a review of theoretical economics the structural problems that lie in the current economic order. The research identified that lack of an ethical foundation, unbridled pursuit of self interest in production as well as in consumption, interest based financial and monetary system are the major problematic issues in Capitalism against which mixed economy has also shown limited effectiveness. Socialism takes fundamental human rights and profit motive away and give way for an autocratic or totalitarian regime. Islamic economic system is a blend of natural features present in Capitalism i.e. right to private property, private pursuit of economic interest, use of market forces etc used along with 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 incentives.

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