



A Comparative Study between Islamic Economic System and Other Major Economic Systems

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Abstract

This paper compares the fundamental postulates of major economic systems i.e. Capitalism, Socialism, Mixed economy (a mixture 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, uncontrolled 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 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 uncontrolled 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.

Key Words:

Economic System; Capitalism; Socialism; Mixed economy; Islamic economic system

1. Introduction

It is a tragedy that humans are regarded as deferential 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 exceptional 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, healthy, unbiased yet a practicable system.

In this conditions, this study takes an analytical approach to revisit the fundamental postulate of major economic systems and identify the structural issues which need to be addressed in the search 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 turn 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 Economists who have to make a choice from among the set of alternatives. To make the economic choices, economists deal with 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 committed 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.

- a. Capitalism
 - b. Socialism
 - c. Mixed Economy
 - d. 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.

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?

Countries have to exchange 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 activates 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 outdated 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 absolute 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 indifference are the hallmarks of the capitalistic society.

4.3. Critical Analysis of Capitalism

Interest is prohibited in all religions. However, interest is pervasive in capitalism. 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".

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.

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 India has a comparative advantage in producing wheat; then, India 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.

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. 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.

5. Socialism

5.1. Fundamental Postulates of Socialism

Some of the pioneer and well known social thinkers include Robert Owen, Charles Fourier, and 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 an originator 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 mission to broken 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. 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 said 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 discount 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 uncontrolled 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 hindrance 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 Allah, 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 Allah. But, it is not a material end confined to this life only. In this way, the serviceable 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 serviceable 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 needy 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

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.

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. Conclusions

This paper evaluated the basic premises of major economic systems i.e. Capitalism, Socialism, Mixed economy (a mixture 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, uncontrolled 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 uncontrolled 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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