# CHAPTER 1
# Economic Systems

**Learning objectives:**

1. ***The differences between economic systems and the role that government plays.***
2. ***How the ideal Islamic system differs from the Western market capitalist system.***
3. ***The role of markets and how they differ in Islam and in the market capitalist system.***
4. ***What institutions are and why they matter for economic prosperity.***
5. ***Governments have an important role no matter the system.***

Over the years, a number of different economic ideologies and systems have been proposed and promoted. As with most other things in life, economic doctrines and systems have a limited shelf life and evolve with time. While in 2014 the mixed capitalist market system of the Western world, especially that in the United States, may appear preeminent, it received a number of shocks at its very foundation. The financial crisis of 2007–2008 with its extensive fallout and the rapid rise of China as an economic power have raised new and fundamental questions about the long-term direction and viability of the laissez-faire mixed capitalist system practiced in the United States and other Western nations.

After World War I, economists generally realized that neoclassical economics was not well equipped to address the reasons underlying unemployment, business cycles, and their mitigation and amelioration. During the Great Depression, John Maynard Keynes's *General Theory of Employment, Interest, and Money* provided some answers.[1] As a result,

[1]Published in London by Macmillan in 1936.

Irving Fisher and Alfred Marshall's neoclassical theories were resurrected and reborn into the Keynesian framework. After World War II, a number of economists, including Hicks, Samuelson, Tobin, Solow, and Modigliani, further developed the Keynesian approach in what came to be known as neo-Keynesian macroeconomics. Although the Keynesian theory of demand management with its further refinement became the most widely accepted macroeconomic framework after World War II, the Chicago school of economics later criticized it, largely on libertarian grounds and on the grounds that it could not explain a number of observed economic developments in the 1970s and 1980s. These economists argued against discretionary macroeconomic policies in favor of the market's "invisible hand" (Adam Smith's famous words that, ironically, were mentioned only once in his famous work, *The Wealth of Nations*) and passive fiscal and monetary policies. Milton Friedman argued against the effectiveness of fiscal policy and instead pointed to passive (by a rule as opposed to discretionary) monetary policy. This approach was further supported and advocated in the early 1970s by Robert Lucas and his followers in their rational expectations framework to macroeconomics. While downplaying the promise of macroeconomic policies to fine-tune the economy, they generally advocated supply-side policies and programs to enhance economic prosperity. Today, in 2014, with the devastating fallout of the financial crisis of 2007–2008 still with us, economists are even more divided about the effectiveness of Keynesian macroeconomic policies and the broader role of government intervention in economic management.

## WHAT IS AN ECONOMIC SYSTEM?

Any economic system is essentially a network of relationships (among households, businesses, and government), organizations, and the framework for producing, distributing, and consuming the goods and services produced in an economy while protecting the rights of future generations to the earth and the environment that all must share. An economic system includes how the output of the economy is produced and divided among members of society, how incentives and decision making are formulated, the extent of government intervention and its provision of goods and services, the role of markets and their regulation and supervision, and, in the legal system of property rights, ownership of factors of production and contracts and their enforcement. Although there are a number of ways to classify the range of economic systems, one classification could divide them into these five traditional economies, market economies, mixed market economies, mixed socialist economies, and command (planned) economies. In 2014, the most prominent economic system is the mixed market economic system, which is still evolving, followed by the mixed socialist economic system, the communist (command) system, and the recent rebirth of the Islamic economic system.

The most critical characteristic that distinguishes economic systems is the *relative* importance of markets and governments in determining what goods and services are produced, how they are produced, and who gets the output. A secondary distinguishing attribute has increasingly become the role of morality and justice in the economic system.

## Traditional Economic Systems

Today, traditional economic systems are those that prevail largely in the tribal regions of a number of developing countries. They are predominantly agricultural with little or no labor specialization. Government services, where governments exist, are severely limited. These economies invariably rely on tradition, customs, and religion to decide what and how goods are produced and distributed, what occupations are chosen, and what form of governance is followed. Paper money is rarely used. Commodities, animals, and land provide a store of wealth, and barter is quite common.

## Pure Market (Capitalist) Economic System

The father of modern capitalist market system was Adam Smith, the author of two books that have shaped the capitalist market economic systems around the world. His most widely cited text is *The Wealth of Nations* (more precisely, *An Inquiry into the Nature and Causes of the Wealth of Nations*), published in 1776. It was preceded by what we consider his masterpiece, the much less quoted *The Theory of Moral Sentiments*, published in 1759. For many mainstream economists, the year 1776 marks the birth of modern economics. In *The Wealth of Nations*, Smith took the bold stance that markets, left alone, were self-regulating and required no government rules, intervention, and regulation, and that government intervention would, in practice, do more harm than good. At the foundation of a market economy is the belief that the best outcome for all involved—namely the maximum output of goods that people want at the lowest price—results from individual sellers and buyers, acting individually and independently through the language of price (as the signaling device). Consumers vote what they want with their purchases; producers respond by producing what is demanded by consumers. If demand goes up, prices increase to balance supply and demand, and the higher price is a signal to producers to increase output. Producers, in pursuit of profits, produce the goods demanded most efficiently depending on the relative price of factors of production (land, labor, and capital) by increasing their inputs into the production process. People acquire goods and services on the basis of their voting power (ownership of factors of production and accumulated wealth).

For Smith, markets worked best if largely left alone. He saw markets as being self-regulating and having the special feature that they afforded the needed incentive to market participants. Profit incentives drive producers to produce the goods and services demanded in the most efficient way. Consumers are given a wide range of choice by registering their demand (what they buy) through the markets and can increase their income through education and savings. Smith coined the now-famous term "invisible hand" that would lead consumers and producers to pursue their self-interest *and*, unknowingly, in the process support the economic interests of all. Smith went even further and also argued that well-intentioned government rules and regulations were not needed and might in fact be detrimental to the growth of economic prosperity. He thus advocated a laissez-faire economic philosophy. This was the foundation of the capitalist economic system that fueled the Industrial Revolution in England and later in the rest of Europe and the United States.

Smith saw markets at the center of the economic system. Markets are not limited to those for final goods and services. Markets for factors of production, labor, and capital work in the same way as those for goods and are just as crucial for a smooth functioning economic system. Without factors of production, goods and services cannot be produced. In fact, one can imagine a market for almost everything in life.

Although Smith preached laissez-faire market economics, he was also a man of God. Smith believed in the deity and that "the Author of Nature" had prescribed the rules of human behavior in all things, including for economic behavior. It was left to humans to operationalize these rules and develop laws to provide the required institutional scaffolding for the ideal and efficient economy, an economy in which the government plays a minimal role but where rules (institutions) and especially the rule of law (and rule enforcement) guide the economy along its ideal path. Smith saw effective institutions as the scaffolding of the economic system. He was anything but the cold-hearted promoter of market economics that has become his mantra in most justifications of laissez-faire market economics. The Smith of *Moral Sentiments* envisaged the market system functioning if market participants complied with rules, including the rules of human behavior that had been prescribed by the Author of Nature. In *Moral Sentiments*, he advocated the importance of morality; he believed that for market participants, the love of self would result in sympathy for others as they entered market (more on this in the following paragraph). Without morality and government rule/legal intervention, the pure market system could lead to a veritable jungle—possibly maximum output but with the rise of harmful monopolies and price gauging; extreme income inequalities (poverty alongside great wealth); inhumane working conditions; discrimination by race, religion, age, and sex; unsafe foods and medicines; harmful spillovers or externalities (such as environmental degradation that is not cleaned up by those responsible); information that is not shared (asymmetric) with all market participants; and broken social systems. In others words, there could indeed be market failure in a number of areas with adverse social consequences. Adam Smith, the champion of free enterprise and limited government intervention, still acknowledged as fact that businessmen left to themselves could not be trusted and that they might take advantage of consumers through collusion or natural monopolies.

Because our description of the "real" Adam Smith may not be familiar to most, it may be helpful to give an extensive quote from his other book—*The Theory of Moral Sentiment.* Smith expresses his remarkable insight regarding rules of conduct, which he believed were:

> *the ultimate foundations of what is just and unjust in human conduct. . . . Those general rules of conduct, when they have been fixed in our mind by habitual reflection, are of great use in correcting the misrepresentations of self-love concerning what is fit and proper to be done in our particular situation. The regard to those general rules of conduct is what is properly called a sense of duty, a principle of the greatest consequence in human life, and the only principle by which the bulk of mankind are capable of directing their actions. . . . Without this sacred regard to general rules, there is no man whose conduct can be much depended upon. It is this which constitutes the most essential difference between a man of principle and honor and a worthless fellow. . . . Upon the tolerable observance of these duties depends the very existence of human society, which would crumble into nothing if mankind were not generally impressed with a reverence for those important rules of conduct. This reverence is still further enhanced by an opinion which is first impressed by nature, and afterward confirmed by reasoning and philosophy, that those important rules of morality are the commands and* Laws *of the Deity, who will finally reward the obedient, and punish the transgressors of their duty. . . . The happiness of mankind as well as of all other rational creatures seems to have been the original purpose intended by the Author of Nature when he brought them into existence. No other end seems worthy of that supreme wisdom and benignity which we necessarily ascribe to him; and this opinion, which we are led to by the abstract*

*consideration of his infinite perfections, is still more confirmed by the examination of the works of nature, which seem all intended to promote happiness, and to guard against misery. But, by acting according to the dictates of our moral faculties, we necessarily pursue the most effectual means for promoting the happiness of mankind, and may therefore be said, in some sense to co-operate with the Deity, and to advance, as far as is in our power, the plan of providence. By acting otherwise, on the contrary, we seem to obstruct, in some measure, the scheme, which the Author of Nature has established for the happiness and perfection of the world, and to declare ourselves, if I may say so, in some measure the enemies of God. Hence we are naturally encouraged to hope for his extraordinary favor and reward in the one case, and to dread his vengeance and punishment in the other. . . . When the general rules which determine the merit and demerit of actions comes thus to be regarded as the* Laws *of an all-powerful being, who watches over our conduct, and who, in a life to come, will reward the observance and punish the breach of them—they necessarily acquire a new sacredness from this consideration. That our regard to the will of the Deity ought to be the supreme rule of our conduct can be doubted of by nobody who believes his existence. The very thought of disobedience appears to involve in it the most shocking impropriety. How vain, how absurd would it be for man, either to oppose or to neglect the commands that were laid upon him by infinite wisdom and infinite power. How unnatural, how impiously ungrateful not to reverence the precepts that were prescribed to him by the infinite goodness of his creator, even though no punishment was to follow their violation! The sense of propriety, too, is here well supported by the strongest motives of self-interest. The idea that, however, we may escape the observation of man, or be placed above the reach of human punishment, yet we are always acting under the eye and exposed to the punishment of God, the great avenger of injustice, is a motive capable of restraining the most headstrong passions, with those at least who, by constant reflection, have rendered it familiar to them.*[2]

As we shall see through this volume, Smith's deist views, the sacred rules of nature, the required legislation, and the well-functioning market system *converge* with what we visualize as an "ideal Islamic system." Viewed in this light, Smith's thoughts then become systematic and complete in the sense

[2]Smith (2006, pp. 186–198).

that the *Moral Sentiments* covers the first part, his *Lectures on Jurisprudence* covers the second part, and *The Wealth of Nations*, the third part. This view holds the promise of opening a line of communication between Islamic economics and conventional economics to illuminate how the original visions of Islam and Smith converge. Our position in this regard is of course diametrically opposed to the position held by most that the two disciplines have nothing in common and that the only way to define Islamic economics is to jettison conventional economics: throw the baby out with the bathwater.

Because of market failures and social considerations, truly pure market economies do not exist today. Instead, market or capitalist economies are mixed systems, with the word "mixed" referring to government participation and intervention. Crucially, the questions have become: How much government intervention is acceptable? In what areas?

## Mixed Market (Capitalist) Economic System

A number of the shortcomings of a pure market economic system have been noted. We also should add that markets need a "referee" to make sure that important market rules are respected and negative fallouts are contained and limited. Markets are the medium for effective economic performance; they are not an ideology to be placed on a pedestal and untouched, as some would have it.

Private property rights and secure contracts are essential features of a market economy. Property rights give individuals the right to own property and to use that property as they wish. Property rights, in turn, are of no value unless they are secure and legally enforced. Similarly, most economic transactions that are outside the simple retail sphere rely on contracts that must be secure and enforced. In other words, business development needs security and confidence. Without government intervention as the referee, business conditions could become problematic. Moreover, in the absence of business regulations, supervision, and enforcement, businesses could collude and fix prices to the detriment of consumers and society at large. Even without price fixing, monopolies could develop to the detriment of society. At the same time, there are a number of areas where there are natural monopolies, such as defense and some areas of infrastructure. Again, we see a role for government. Most important, even if markets are self-regulating and operate smoothly without government intervention, (namely, how market output is divided among members of society) they may yield results that are socially abhorrent—a few wealthy individuals alongside mass poverty. And most practically, governments needing revenues have to collect taxes to provide even the minimum level of public and social services.

### Mixed Socialist Economic System

In large part because of significant income inequality, poverty, human dissatisfaction, and increasing social concerns, some mixed market economies adopted a socialist mantle as an offshoot of Marxism. In Western Europe, socialist parties emerged as strong political contenders to nurture key nationalized industries and expand the available welfare programs. Some countries adopted limited industrial plans. Key sectors, such as banking, telecommunications, railroads, energy, healthcare, and education, were nationalized. The provision of social benefits was expanded to include free education and healthcare, extended unemployment benefits, early retirement for those in hardship industries, minimum retirement benefits, and reduced working hours. These programs increased the role and economic contributions of the state while reducing the role of markets. In the 1980s, the United Kingdom reversed a number of earlier socialist decisions, denationalized some industries, and reduced a number of social programs. This reversal of socialist policies and programs spread to a number of other countries in Western Europe. It was adopted by the International Monetary Fund as the recommended policy prescription and was even forced on some countries during the financial crisis of 2007–2008, in part because of significant public debt and the belief that societies could no longer afford what became considered to be social programs that were too generous.

### Command (Planned) Economic System

A command or planned economic system is the polar opposite of a market-based economy. In a command economy, a central public authority makes decisions on the specific goods to be produced, decisions that would be made by individual producers and consumers in a market system. Moreover, in a command economic system, there are no private property rights. Property and resources are collectively owned by groups or by the state. The state or planning organization determines the output of each final good and service sector and those of intermediate goods and services. It decides on wages to be paid and on all remuneration of incomes. From these wage and income figures, consumption and savings are determined. In order to have useful consumption (demand) figures, the planning directives literally go down to the kind and even sizes of shoes to be produced. The output of shoes is so specified (what to be produced), and the inputs have to be dictated (how the goods are produced and the required materials), and so on down the line. In a planned economy, the authorities use an input-output model to derive the needed inputs of different sectors. The planners determine prices and thus the incomes (who can buy the economy's output).

Thus the planning entity determines all that the markets do “invisibly” in a market system.

In practice, no planner can predict individual demands for goods as well as the invisible hand of the market as consumers register their votes (by what they demand) and prices send the signal to producers. Similarly, planners cannot tell producers the best (most efficient) way to combine the inputs they need to produce the planned output. Instead, producers who have the profit incentive and who know the technologies and the relative cost of inputs are best placed to produce the highest-quality output at the lowest cost. Moreover, there is little incentive to innovate and work hard in a system where there are no private property rights and no ownership. It is easy to see why it would be difficult to develop a thriving economy in such a system. Economic waste, chaos, and stagnation are the likely outcome.

Planned economies had their heyday after World War II in the Soviet Union and China but lost their cachet as the Soviet economy faltered. With the collapse of the Soviet Union, the mixed market economic system began to rule almost supreme. Russia turned to a market-supported system through shock therapy, and China started to gradually move toward a market-based system. We say “almost supreme” because income and wealth inequalities became glaring in a number of market economies. Economists began to question the relative importance of economic output for individual well-being as material success was no longer seen as synonymous with human happiness and welfare. Since the financial crises of the 1980s, excessive national debt and, more recently, the most serious economic downturn and stagnation since the Great Depression have renewed doubts about the ability of markets and governments to deliver economic prosperity and well-being.

## CURRENT STATE OF THE GLOBAL ECONOMIC SYSTEM

Due to market failure and other reasons, there is no “pure” market economy in the world of 2014. There is a role for governments in any economic system, and hardly anyone denies an important role for the government. The questions relate to the areas and extent of government intervention. Generally speaking, the wealthy argue for very limited government intervention and low taxes to maximize their earnings and wealth, while the poor want extensive intervention to address unequal opportunities (education and healthcare), wealth disparities, and social safety nets.

But even though they recognize these safeguards and address them, mixed market economies in practice all over the globe have come under considerable criticism. In 2014, there are five major criticisms of the mixed market economic system:

1. Wide and growing income and wealth disparities
2. Recurring and highly disruptive financial crises accompanied by rising unemployment and severe economic hardships, especially for the poorer segments of society
3. Neglect of the human and societal well-being dimension of economic development
4. Irrational assumption of rational self-interest
5. Continuing environmental degradation

## Growing Income and Wealth Disparities

In the United States, for example, income and wealth inequalities have deteriorated significantly over time.[3] In 1982, those in the top 1% of the U.S. income distribution received 12.8% of the total national income; this percentage rose to 21.3 by 2006 and fell back to 17.2 in the aftermath of the financial crash of 2007–2008. Another popular indicator of growing income disparity is a comparison of average chief executive officer pay relative to the pay of an average factory worker; this ratio rose from 42 times in 1960 to a high of 531 in 2000 and fell back to 344 in 2007. An often-used comparator of income distribution across countries is the Gini coefficient (with zero representing perfect equality and 100 representing total inequality, or in other words, one person earning the entire national income); the most recent numbers for some countries are:

United States: 45.0

Iran: 44.5

Japan: 38.1

Egypt: 34.4

United Kingdom: 34.0

Switzerland: 33.7

France: 32.7

Norway: 25.0

Sweden: 23.0

[3] For the U.S. data cited here, see G. William Anderson, "Who Rules America?" (http://www2.ucsc.edu/whorulesamerica/power/wealth.html). For Organisation for Economic Co-operation and Development (OECD) data, see "Growing Unequal? Income Distribution and Poverty in OECD Countries" (http://www2.ucsc.edu/whorulesamerica/power/wealth.html).

The rankings among 133 countries (with 1 representing the most equal income distribution among countries, namely Sweden):

South Africa: 133

United States: 93

Iran: 90

Sweden: 1

A standard method of addressing income inequality in a capitalist system is through progressive taxation. But this is not always the case in countries that profess progressive taxation. As the following article excerpt notes:

> *The lowest 20% of earners (who average about $12,400 per year), paid 16.0% of their income to taxes in 2009; and the next 20% (about $25,000/year), paid 20.5% in taxes. So if we only examine these first two steps, the tax system looks like it is going to be progressive.*
>
> *And it keeps looking progressive as we move further up the ladder: the middle 20% (about $33,400/year) give 25.3% of their income to various forms of taxation, and the next 20% (about $66,000/year) pay 28.5%. So taxes are progressive for the bottom 80%. But if we break the* top *20% down into smaller chunks, we find that progressivity starts to slow down, then it stops, and then it slips backwards for the top 1%.*
>
> *Specifically, the next 10% (about $100,000/year) pay 30.2% of their income as taxes; the next 5% ($141,000/year) dole out 31.2% of their earnings for taxes; and the next 4% ($245,000/year) pay 31.6% to taxes. You'll note that the progressivity is slowing down. As for the top 1%—those who take in $1.3 million per year on average—they pay 30.8% of their income to taxes, which is a little* less *than what the 9% just below them pay, and only a tiny bit more than what the segment between the 80th and 90th percentile pays.*

While income figures represent one measure of inequality, a more comprehensive measure is wealth; these figures are even more discouraging. In 2000, the percentages of the national wealth held by the top 10% of the adult population in a number of Western countries were:

Switzerland: 71.3

United States: 69.8

France: 61.0

Sweden: 58.6
Norway: 50.5
Germany: 44.4
Finland: 42.3

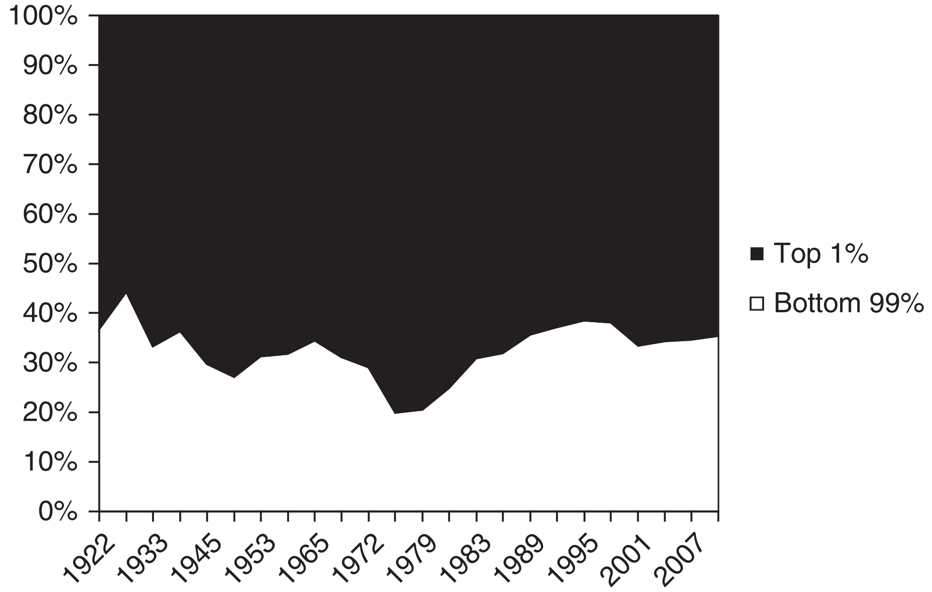


**FIGURE 1.1** Share of Wealth Held by the Bottom 99% and Top 1% in the United States, 1922–2010

The numbers for the United States, where figures are readily available, are even more alarming when we look at the top 1%. (See Table 1.1 and Figure 1.1.) Generally speaking, in 1976, the top 1% held about 20% of the total national wealth. This figure nearly doubled to 40% in 1995 and in 2010 stood at over 35%. The corresponding dollar figures (wealth and income) for the various percentiles are shown in Table 1.2.

## Instability of Economic and Financial Systems

A second major criticism of the mixed market system is the recurring financial crises and the heavy economic toll that follows, especially on the less fortunate members of society. While the Great Depression and the financial crisis of 2007–2008 are the two most prominent standouts, they are not alone.[4] The conventional financial system is based on fractional reserve banking and debt, whereby banks create money though loans and investors

[4]Kindleberger (2011).

**TABLE 1.1** Share of Wealth Held by the Bottom 99% and Top 1% in the United States, 1922–2010

| | Bottom 99% | Top 1% |
|---|---|---|
| 1922 | 63.3% | 36.7% |
| 1929 | 55.8% | 44.2% |
| 1933 | 66.7% | 33.3% |
| 1939 | 63.6% | 36.4% |
| 1945 | 70.2% | 29.8% |
| 1949 | 72.9% | 27.1% |
| 1953 | 68.8% | 31.2% |
| 1962 | 68.2% | 31.8% |
| 1965 | 65.6% | 34.4% |
| 1969 | 68.9% | 31.1% |
| 1972 | 70.9% | 29.1% |
| 1976 | 80.1% | 19.9% |
| 1979 | 79.5% | 20.5% |
| 1981 | 75.2% | 24.8% |
| 1983 | 69.1% | 30.9% |
| 1986 | 68.1% | 31.9% |
| 1989 | 64.3% | 35.7% |
| 1992 | 62.8% | 37.2% |
| 1995 | 61.5% | 38.5% |
| 1998 | 61.9% | 38.1% |
| 2001 | 66.6% | 33.4% |
| 2004 | 65.7% | 34.3% |
| 2007 | 65.4% | 34.6% |
| 2010 | 64.6% | 35.4% |

**TABLE 1.2** Income, Net Worth, and Financial Worth in the United States by Percentile, in 2010 dollars

| Wealth or Income Class | Mean Household Income | Mean Household Net Worth | Mean Household Financial (Non-Home) Wealth |
|---|---|---|---|
| **Top 1%** | $1,318,200 | $16,439,400 | $15,171,600 |
| **Top 20%** | $226,200 | $2,061,600 | $1,719,800 |
| **60th–80th percentile** | $72,000 | $216,900 | $100,700 |
| **40th–60th percentile** | $41,700 | $61,000 | $12,200 |
| **Bottom 40%** | $17,300 | –$10,600 | –$14,800 |

and consumers borrow to finance investment and consumption. The assumption of excessive debt, or leveraging, exposes the financial system to bad decisions and debt that cannot be repaid, setting off a chain reaction of defaults among financial institutions and causing panic and requiring government bailouts that become a burden for average taxpayers. Moreover, serious financial crises, most notably the Great Depression and the financial crisis of 2007–2008, lead to panics, loss of business and consumer confidence, deleveraging, severe and prolonged recessions or depressions, long-lasting periods of high unemployment, and, ultimately and most ominously, unbearable pressure on families and on the fabric of society and social cohesion.

### Neglect of Human Welfare Dimension of Economic Development

A third criticism of mixed market economies is the focus on gross domestic product (GDP) and not on the happiness, well-being, and welfare of individuals and society at large. In the West, under the mixed market system, the focus of economic policy is largely GDP and GDP per capita, not on the condition of all humans. Human beings are *not the end* result of all economic activity but are taken in part *as inputs* to economic production, and the economic goal has become how much goods and services are produced. Thus, other goals, especially human well-being, freedom to pursue individual goals, and social cohesion, have fallen by the wayside. These shortcomings became increasingly recognized in the West during the late 1970s and 1980s through the works of Mahbub ul-Haq and Amartya Sen.

Mahbub ul-Haq argued that all development and growth models following World War II considered humans, whether as labor or human capital, to be an input into the production process and therefore a means for development. What was missing, he asserted, was the consideration of the human as the end of the development process. He developed the idea of "basic needs," which laid the foundation for his later work on "human development," culminating in the publication of the *Human Development Report* in 1990. As he says in his book, *Reflections on Human Development*, "After many decades of development, we are rediscovering the obvious—that people are both the means and the end of economic development."[5] In his foreword to ul-Haq's book, Paul Streeten defines human development as "widening the range of people's choices. Human development is a concern not only for poor countries and poor people, but everywhere. In the high-income countries, indicators of shortfalls in human development should be looked for in

[5] Ul-Haq (1995, p. 3).

homelessness, drug addiction, crime, unemployment, urban squalor, environmental degradation, personal insecurity and social disintegration." Aside from the recommendation that economic development should focus on humans as ends as well as means, Mahbub ul-Haq concentrated on enhancing human productivity as a means of development, arguing that the labor force is productive when it is well nourished, skilled, and well educated.

The Human Development Index (HDI) was an attempt to devise a technical means to provide an indication of a society's level of human development and to measure its progress through time. In its initial formulation, the HDI included three variables:

1. Per capita GDP, calculated at the real purchasing power exchange rate
2. Literacy rates
3. Life expectancy at birth

This was the first major attempt to focus attention away from the growth of GDP as the measure of the development and progress of countries. By introducing literacy and life expectancy, the HDI broadened the information base of the meaning of development. Any increase in HDI could be interpreted as an improvement in the society since progress on education and health benefits the society as a whole. To a degree, the inclusion of health and education in the original HDI corrected the distributional ambiguity contained in per capita GDP as the only indicator of economic progress since it can conceal large income inequalities. The HDI also made it possible to produce a ranking of countries that would give some indication of drawbacks to affluence by showing "the troubles of overdevelopment—or, better, maldevelopment—as well as those of underdevelopment. Diseases of affluence can kill, just as the diseases of poverty can. Income statistics, by contrast, do not reveal the destructive aspects of wealth," as reported by the 1990 Human Development Report (HDR). It is thus possible for a country to rank low in terms of per capita GDP but high in terms of HDI.[6]

Amartya Sen's concept of "development as freedom" was an effort to further modify, expand, and enhance the meaning of development. Sen expanded the theoretical and empirical dimension of human development from its definition as "both the process of widening people's choices and the level of their achieved well-being" to its culmination as "freedom." The 1990 HDR had identified well-being as including, among others things: access to income; health, education, and long life; political freedom; guaranteed human rights; concern for the environment; and concern for participation. Under the influence of Sen and his colleagues, this view was revised to suggest

[6]Ul-Haq (1995, pp. 46–66).

that the goal of development is "to secure the freedom, well-being and dignity of all."[7]

Sen notes that in an age of "unprecedented opulence," there is also "remarkable deprivation, destitution and oppression." In both rich and poor countries, there are, in one form or another, problems of "persistence of poverty and unfulfilled elementary needs, occurrence of famines and widespread hunger, violation of elementary political freedoms as well as of basic liberties, extensive neglect of the interests and agency of women, and worsening threats to our environment and to the sustainability of our economic and social lives. Overcoming these problems is a central part of the exercise of development."[8]

Sen argues that it is the individual agency (the capacity for human beings to make choices and to impose those choices on the world) and social arrangements that, deeply complementing each other, determine the extent to which problems and deprivations can be addressed successfully. Freedoms of various kinds are essential to the exercise of human agency. Social arrangements, in turn, determine the extent of human freedom and agency; individual freedom has to become a social commitment so that human agency can become effective in solving problems. Sen conceives of the expansion of freedom "both as the primary end and as the principal means of development. Development consists of the removal of various types of 'unfreedoms' that leave people with little choice and little opportunity of exercising their reasoned agency. The removal of substantial unfreedoms, it is argued here, is constitutive of development." Freedom is multidimensional and "instrumental effectiveness by freedoms of particular kinds to promote freedoms of other kinds" serves to promote freedom as the "preeminent objective of development." These instrumental freedoms include political freedoms, economic facilities, social opportunities, transparency guarantees, and protective security.[9]

Although the human dimension became recognized, little has changed in economic management and policy in the West. In these mixed market economies, all eyes are glued to quarterly and annual GDP growth with a smattering and infrequent reference to poverty and income inequality here and there. While there are many valid criticisms of modern-day capitalist mixed economies, they still generally are perceived to be the most efficient in delivering economic output and growth, and international institutions such as the World Bank and the International Monetary Fund continue to recommend most of the capitalist prescriptions. But economic efficiency

[7]Sen (1999, p. xv).
[8]Ibid., p. xii.
[9]Ibid., pp. xii–xiii.

does not necessarily embrace economic justice, human well-being, and social harmony.

## Irrational Assumption of Rational Self-Interest

In recent years, more and more economists have raised serious questions regarding the basic postulates of the classical-neoclassical economic paradigm. Aside from those who have focused their criticism on the separation of economics from ethics, such as Amartya Sen, others have focused on the postulate of rational self-interest of the paradigm without rejecting its other features. One example is the position of two prominent economists, George Akerlof and Robert Shiller. In their book *Animal Spirits*, they revive the concept of "animal spirits" proposed by Keynes, saying that Keynes "appreciated that most economic activity results from rational economic motivation—but also that much economic activity is governed by animal spirits." While accepting that "people rationally pursue their economic interests," they, along with Keynes, argue that exclusive adherence to this view ignores "the extent to which people are also guided by non-economic motivations. And it fails to take into account the extent to which they are irrational or misguided. It ignores the animal spirits."[10]

The concept of animal spirits refers to a restless and inconsistent element in the economy. It refers to our peculiar relationship with ambiguity or uncertainty. Sometimes we are paralyzed by it. Yet at other times it refreshes and energizes us, overcoming our failures and indecisions. According to Akerlof and Shiller, the animal spirits have "five different aspects," each of which "affect[s] economic decisions: confidence, fairness, corruption and antisocial behavior, money illusion, and stories." Confidence derives from the basic trust that people have in one another, the market, and the state "and the feedback mechanisms between 'confidence' and the economy that amplify disturbances." Fairness concerns "the setting of wages and prices." This theory acknowledges corruption and other social behaviors as playing a role in the economy and affecting it. The theory also revives another Keynesian concept, "money illusion," which refers to the fact that people are often fooled by nominal values of economic variables, such as wages, prices, income, and wealth. They are "confused by inflation or deflation" and do not "reason through its effects." Finally, by the stories aspect of animal spirits, Akerlof and Shiller mean the sense of identity people hold of themselves, their economy, and society. "Our sense of reality, of who we are and what we are doing, is intertwined with the story of our lives and of the lives of others. The aggregate of such stories is a national or

[10] Akerlof and Shiller (2009, p. ix).

international story, which itself plays an important role in the economy." Of the five aspects, Akerlof and Shiller consider confidence and money illusion as the cornerstones of their theory. They believe their theory, with its central concept of animal spirits, describes how the economy works. "It accounts for how it works when people really are *human*, that is, possessed of all-too-human animal spirits. And it explains why ignorance of how the economy really works has led to the current state of the world economy, with the breakdown of credit markets and the threat of collapse of the real economy in train."[11]

This digression on the view of Akerlof and Shiller demonstrates how little the classical-neoclassical economic paradigm has advanced its view of humankind, perhaps the most important cornerstone element of any social science theory. It has lasted from the eighteenth to the twenty-first century, from considering man as a purely self-interested egoist of the classical economics to the "rational" self-interested egoist of the neoclassical economics of the twentieth century and finally to the "animal spirits"–motivated, "rational" self-interested egoist of the twenty-first-century neoclassical-Keynesian hybrid conception of Akerlof-Shiller.

### Negative Impact on Environment

A fourth major area of concern has been the continuing degradation of the environment and the inability of the global economic system to reverse years of environmental neglect. Generally speaking, the neglect of the environment is classified as a negative economic externality; it is the fallout of economic activities, such as electricity production, or of the manufacturing of goods, such as steel. Producers of electricity, whether using coal, oil, or natural gas, produce as by-products pollutants that damage the environment. In other words, buyers of electricity do not pay for the full cost of its production. Similarly, drivers do not pay the full price for gasoline; they pay for gas but not for the resulting pollution caused by their driving. All modern economies fail to address the environmental damage that their economies, and their citizens more generally, cause. One reason is that a major part of the environmental damage is passed on to future generations who have no vote in what goes on today. Environmental damage is not only local. Countries argue that meaningful policies to reverse global environmental damage, such as global warming, require international agreement, something that is elusive because most countries are not willing to sacrifice their economic output if they can put it off, especially if all countries (no matter

[11]Akerlof and Shiller (2009, pp. xi, 4–5).

what their past contribution to environmental degradation) do not make a similar sacrifice.

## ISLAMIC ECONOMICS PARADIGM

Islam is a rules-based system with a prescribed method for humans and society to achieve material and nonmaterial progress and development grounded in rule compliance and effective institutions. The foundations of the Islamic economic system were laid down centuries ago in the Quran and practiced by the Prophet Muhammad in Medina during his brief time on this plane of existence. These rules laid down by the Almighty (swt) are at the foundation of the Islamic system and provide the required effective institutions. The institutional scaffolding of the Islamic economic system is thus formed by the rules of behavior defined by the Quran. As a result, the content and blueprint of Islamic economics is derived by: (1) extracting the rules that define an ideal Islamic economy and their economic implications from the Quran and the *Sunnah* (the teachings and the practice of the Prophet Muhammad [sawa]); (2) studying these institutions in the contemporary economy and determining the degree and extent of deviation between institutional scaffolding and that of the ideal Islamic economy; and (3) prescribing policy recommendations to bridge the gap between the two.

The Islamic economic system is a market-based system, where markets are seen as the best and most efficient mechanism for resource allocation (production and consumption). But efficiency of the market system must not be confused with markets as an ideology, whereby unfettered markets are seen as philosophy or the basis of the economic system, something to be revered, untouched, and placed on a pedestal. To be efficient, markets must have rules (such as information disclosure) to protect market participants (workers, producers, investors, and consumers) and must be supervised with strict rule enforcement. Private property that is legally acquired is held sacred in Islam, and property rights are fully protected. However, according to Islam, Allah (swt) is the Creator of all things on this earth and His creation has been given to humans of all generations in trust. Thus land and other natural resources must be developed in ways that benefit all humans of all generations equitably. It is imperative that the rights of the disabled and those of future generations are fully honored.

A major feature of the Almighty's rules, conveyed in the Quran and practiced by the Prophet (sawa), is *justice*. Thus the Islamic institutional scaffolding and the ideal Islamic economy exude justice. As a result, the promotion of social and human development on this plane of existence is founded on rules that promote justice. The Prophet (sawa) understood the essential objective of the message to encourage and insert justice in human societies as emphasized in the Quran. The Prophet (sawa) taught the responsibility of the individual, the collectivity, and the state. He particularly emphasized the equality of individuals before the law and that all rules that are incumbent on individuals and the collectivity must be more strictly observed by those in positions of authority, as illustrated by his famous saying: "Authority may survive disbelief but not injustice." Insistence on justice became the hallmark of the institutional scaffolding of governance, a structure with full transparency and accountability. Rule compliance that embraces the pursuit of social justice is a requirement of each and every Muslim during every day of his or her life on this earth. Justice is essential in all endeavors, as the pursuit of justice leads to spiritual fulfillment and brings humans closer to their Creator. Rule compliance and justice cannot be compromised. In Islam, social and human development is multidimensional and goes well beyond the highest level of GDP and GDP per capita. Human spiritual pursuits on this earth cannot be compromised for material ends.

In Islam, conventionally measured GDP per capita and GDP growth are not society's only economic goals. There are overriding spiritual, moral, and human dimensions to all economic endeavors. Humans need bread to live but do not live by bread alone. The goal of progress and development is the overall well-being of humans and society. While this has been the goal in Islam, it began to be recognized through the work of Mahbub ul-Haq, Amartya Sen, and numerous other economists in conventional economics only in the late 1970s. Moreover, in Islam, institutions have been seen as an essential element and the foundation of achieving human and economic development. This idea became popular in conventional economics only about 30 or so years ago; it had been almost forgotten from the writings of Adam Smith with the emergence of neoclassical economics. Institutions are the formal and informal laws and rules that shape political and economic structures of society to reduce risk and increase trust. Risk reduction and trust enhancement in turn support economic progress and prosperity.[12]

## SHORT HISTORY OF ECONOMIC THOUGHT IN ISLAM

The last section provided a general description of Islamic teachings on economics, but we cannot sidestep a number of inescapable questions. Namely, given our claim that Islamic teachings on the economic system are based on the morality and ethics of centuries ago, why have the contributions of Islamic

[12]For a detailed discussion of these points, see Mirakhor (2010).

economics not entered into mainstream economics? Why is it that apparently none of the concepts of conventional economics is based on Islamic economics? And why is it that Islamic economics is not more developed as a social science so that it could be at least taught in Muslim countries as a stand-alone economic system? While space limitations preclude a full discussion, brief references may begin to address the issues.

Mirakhor made one of the early attempts to point to the neglect of Muslim contributions to modern economics.[13] It is disheartening that after discussing Greco-Roman economics, Joseph Schumpeter in his magnum opus, *History of Economic Analysis*, states: "So far as our subject is concerned we may safely leap over 500 years to the epoch of St. Thomas Aquinas (1225–1274) whose Summa Theologica is in the history of thought what the south-western spire of the Cathedral of Chartres is in the history of architecture."[14]

This statement is the reason he titles this section of Chapter 2 of his book "The Great Gap." The implications of this statement, as well as the rest of the material in this section of Schumpeter's book, is that for 500 years nothing was said, written, or practiced that had any relevance to economics. In this respect, Schumpeter was merely reflecting an attitude in the coverage of the history of economic thought existing since the late 1800s. The fact that his book became the locus classicus of all works on the history of economic thought only means that this idea would continue from that time on. It is a demonstrable fact that almost all books about the history of economic thought to present-day textbooks echo Schumpeter's sentiments about economic thought prior to the Scholastics (the philosophers who were responsible for the economic thinking in the medieval period, which lasted from 500 to 1500).

Whatever may have been Schumpeter's reason for not recognizing and acknowledging the influence of Muslim scholars, the results were unfortunate for the history of economic thought. The fact that his book became such a celebrated reference in the discipline helped perpetuate what we may call a blind spot in the field that has continued to the present. Even if scholars wish to ignore the research in the history of philosophy, theology, ethics, and science, the mere fact that anyone who consults original writings of medieval scholars can see references to names such as Alfarabius (Al-Farābī), Avicenna, Averroes, and Algazal (Al-Ghazālī) should raise questions regarding their roles in the development of economic thought.

A number of early Muslim contributions included discussion of ideas on taxation, market regulation, usury, permissible economic behavior, wages, prices, division of labor, money as medium of exchange and as unit of account,

[13]Mirakhor (2003).
[14]Schumpeter (1954, pp. 73–74).

admonition against debasement of money, coinage, price fluctuations, and, finally, ethical prescriptions regarding observance of the mean. These works have shown that during the first two and a half centuries of Islam, ideas were developed regarding fiscal policy, monetary policy and institutions, credit and credit instruments, price determination and price policy, market and market regulation, commodity exchange, usury, government budgets, use of taxation as a tool to encourage production and discourage accumulation of wealth, public treasury, deficit financing, methods of balancing governmental budgets, supply and demand, checking and savings accounts, rudiments of banking institutions and procedures on formation of partnerships and commenda contracts, and monopoly.

By the ninth century, many of these ideas had appeared in writing in the form of Islamic legal (*fiqh*) manuals. Udovitch's studies on commercial techniques, credit, and credit instruments existing in the world of Islam by the ninth century was based on analysis of these types of manuals as well as mercantile manuals of early periods of Islam. Based on his studies, Udovitch suggests: "The earliest Muslim legal sources now justify the assertion that already in the late eighth century, and possibly earlier, credit arrangements of various types constituted an important feature of both trade and industry" in the Islamic world.[15] Similarly, the works of Abul-Fadl Ad-Dimashqi, a ninth-century scholar, show advanced ideas regarding value theory, cost and price determination.

As discussed in Chapra, historical records reveal a number of important early contributions by Muslim scholars to the development of Western economic thought and the Enlightenment movement in Europe. Unfortunately, with the passage of time, these contributions were either forgotten or attributed to others. Chapra similarly identifies a number of important Muslim contributions from secondary sources centuries before they were identified and incorporated in conventional economics, including:

> *interdisciplinary approach; property rights; division of labor and specialization; the importance of saving and investment for development; the role that both demand and supply play in the determination of prices and the factors that influence demand and supply; role of money, exchange, and market mechanism; characteristics of money, counterfeiting, currency debasement, and Gresham's law; the development of che[cks], letters of credit and banking; labor supply and population; the role of the state, justice, peace, and stability in development; and principles of taxation.*[16]

[15]Udovitch (1970).
[16]Chapra (2010, p. 10).

Chapra discusses some of these contributions in more detail and goes on to describe how these and other contributions of Muslim scholars were ignored:

> *to remove the concept of the "Great Gap" of "over 500 years" that exists in the history of conventional economic thought as a result of the false assumption by Joseph Schumpeter in his book,* History of Economic Analysis *(1954), that the intervening period between the Greeks and the Scholastics was sterile and unproductive. This concept has become well embedded in the conventional economics literature as may be seen from the reference to this even by the Nobel Laureate, Douglas North, in his December 1993 Nobel lecture (1994, p. 365). . . . Even the Scholastics themselves had been greatly influenced by the contributions made by Muslim scholars. The names of Ibn Sina (Avicenna, d. 1037), Ibn Rushd (Averroes, d. 1198) and Maimonides (d. 1204) (a Jewish philosopher, scientist, and physician who flourished in Muslim Spain), appear on almost every page of the thirteenth century summa (treatises written by scholastic philosophers) (Pifer, 1978, p. 356).*[17]

And Chapra goes on to explain the reason for the decline of Muslim economic progress:

> *The trigger mechanism for this decline was, according to Ibn Khaldun, the failure of political authority to provide good governance. Political illegitimacy, which started after the end of* khilafah *in 661 gradually led to increased corruption and the use of state resources for private benefit at the neglect of education and other [n]ation-building functions of the state. This gradually triggered the decline of all other sectors of the society and economy.*[18]

Even a cursory reading of the writings of the last century by Muslim scholars, social critics, and pamphleteers—beginning perhaps with Jamaluddin Asadabadi (better known as Afghani) and his students, such as Muhammad 'Abduh, Hassan al Banna, Sayed Qutb, Allamah Dr. Muhammad Iqbal, Sayyid Abul A'la Mawdudi, Shaheed M.B. Sadr, and Fazlur Rahman to social critics such as Malik Ben Nabi and Ali Shari'ati, and to contemporary scholars reveals a conviction that Islam has solutions to people's contemporary problems.

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[17] Chapra (2010, pp. 11–21).
[18] Ibid., p. 11.

## BOX 1.1 SHORT HISTORY OF ISLAMIC ECONOMIC THOUGHT

Siddiqi (2010) divides the history of economic thought of Muslims into three periods. The first period lasted from after the *hijra* (the migration of the Prophet (sawa) and his followers from Mecca to Medina) until AH 450 (AD 1058). In this period, *fuqaha* (jurists) and philosophers emerged. Some eminent scholars of this period are Abu Yusuf, Muhammad bin Al-Hassan, Abu Ubayd, and Junayd Baghdadi.

The *fiqh* concentrated on the requirements of *Shariah*, and economic issues were discussed in this context. *Fuqaha* separate the *maslaha* (utility) and *mafsada* (disutility) in economic activities. Jurists treated economics as a normative endeavor. The contributions of Sufis to economic thought can be summarized as an important attempt to give a low weight to material pursuits in favor of altruism and unselfish service to others. The philosophers' thoughts were global and rational. Their approach was toward an ideal society. In this sense, they concentrated on macro issues while jurists focused on micro issues.

The second phase lasted from AH 450 to 850 (AD 1058 to 1446). This period witnessed a flourishing of Islamic economic thought. Abu Hamid Al-Ghazali, Taqiuddin Ibn Taymiyah, and Ibn Khaldun were the eminent scholars of this period. Ali-Ghazali believed that individuals should satisfy only their basic needs, not more or less. Ibn Taymiyah concentrated on the need for society to establish a moral foundation for economic pursuits according to *Shariah*. He asserted that a ruler must preserve justice in transactions and introduced the institution of *hisab* (account) and the concept of fair price in transactions. Ibn Khaldun explained the reasons for the fall and rise of civilizations. He also discussed the importance of the division of labor and the role of trade in growth. He believed in the minimal role of the state in economic activities.

The third period lasted five centuries, AH 850 to 1350 (AD 1446 to 1932). This period is characterized by stagnation in intellectual and individual thinking. Among the scholars of this time, Shah Waliullah explained the rationality of *Shariah* rules for conducting individual and social dealings. He believed taxation to be a necessary policy for governments to provide enough funds for public needs, such as maintaining roads. However, he was strongly opposed to heavy taxes. He also believed that extravagance, luxury, and opulent living invariably led to the downfall of civilizations.

*Source:* Mohammad Nejatullah Siddiqi, "History of Islamic Economic Thought," in *Handbook of Islamic Economics*, edited by Habib Ahmed and Muhammad Sirajul Hoque, vol. 1: 95–110. (Jeddah, Saudi Arabia: Islamic Research and Training Institute, 2010).

The second important conviction articulated in these writings is a deep belief that Islam has prescribed rules of behavior for individuals and societies to comply with that assures felicity on this earth and in the hereafter. The third conviction expressed, in one form or another, is that the malaise of Muslim societies stems from general noncompliance with the rules of behavior prescribed by the Lawgiver.

Systematic focus on economic issues, however, began in earnest in the 1950s with Sayed Qutb's book, *Social Justice in Islam.*[19] The challenge of the two dominant systems—capitalism and socialism—and their attraction for Muslim youth during the 1950s, 1960s, and 1970s made the task of articulating an Islamic response ever more urgent. The first to respond to the challenge, positioning Islam's view on economic matters between capitalism and socialism, was Sayyid Abul A'La Mawdudi.[20] His writings and those of his students, especially Professor (Senator) Khurshid Ahmad, became a major source of thought and the standard bearer of ideas for Islamic economics.

The 1960s represent a watershed in the progress to articulating a vision of the Islamic economic system firmly grounded on the Quran and the *Sunnah*. The publication in 1968 of Shaheed M. B. al Sadr's book, *Iqtisaduna* (*Our Economics*), initiated a new approach in articulating Islam's vision of an economy that serves society's needs.[21] Monzer Kahf

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[19]The book was first published in or about 1945 in Egypt but did not become available in the rest of the Muslim world until the 1950s. It was translated into English much later by John B. Hardie as *Social Justice in Islam* (Lahore: Islamic Book Services, n.d.).

[20]For a recent rendition of Maulana Mawdudi's ideas on Islam and economics, see Ahmad (2011). This book competently culls and integrates Mawdudi's ideas from various pamphlets, speeches, sermons, and writings.

[21]See also an enlightening essay by perhaps the most brilliant student of Al Sadr, Ammar Abu Raheef, in Al–Hassani and Mirakhor (2003).

suggests that *Iqtisaduna* became a shining beacon that began a new era in Islamic studies and marked the birth of Islamic economics.[22] The central focus of the book is identifying the architecture of the Islamic economic system and then examining and understanding the behavior of its constituent elements. These are then the tasks of the discipline of Islamic economics. It is noteworthy that *Iqtisaduna* was written after al Sadr had already published *Falsafatuna* (*Our Philosophy*), a book that established the ethico-philosophical framework in which *Iqtisaduna* was later envisioned.[23]

## SUMMARY

An economic system covers the type of relationships among households, businesses, and government and the framework for producing, distributing, and consuming the goods and services produced in an economy. A critical dimension of the economic structure is the extent of government intervention, the role of markets and their regulation and supervision, the legal system of property rights, ownership of factors of production, and contracts and their enforcement. The basic issues to be addressed are what goods and services are produced and how and for whom they are produced. Although there are a number of ways to classify the range of economic systems, one classification could be traditional economies, market economies, mixed market economies, mixed socialist economies, and command (planned) economies.

Adam Smith is widely considered to be the father of the modern capitalist market system. The Great Depression and the imploding global economy shook up the economics profession. In response, Keynes put

[22]Monzer Kahf, "Definition and Methodology of Islamic Economics Based on the Views of Imam al Sadr," paper presented in the International Conference on Imam Sadr's Economic Thoughts, Qum, Islamic Republic of Iran, May 2006.

[23]This book was published first in 1960 and *Iqtisaduna* in 1961. There is a parallel with Adam Smith who wrote his ethico-philosophical work, *The Theory of Moral Sentiments*, long before his more famous book, *The Wealth of Nations*. Until very recently the economics profession made no serious attempt to connect the two. The result of this disconnect has been the development of a "science" of economics divorced from the ethical foundations so strongly articulated and advocated in *The Theory of Moral Sentiments* by Smith, the father of the market economic system. Similarly, a study of *Falsafatuna* would provide a more complete understanding of *Iqtisaduna*. See also the essay by Ragheef in *Iqtisad*.

forward his book titled *General Theory of Employment, Interest, and Money* to provide some answers. A number of economists further developed the Keynesian approach in what came to be known as neo-Keynesian macroeconomics. Although the Keynesian theory of demand management has become the most widely accepted macroeconomic framework, the Chicago school of economics later criticized it, largely on libertarian grounds and because it could not explain a number of observed economic developments in the 1970s and 1980s. These economists argued against discretionary macroeconomic policies in favor of the market's invisible hand and passive fiscal and monetary policies. In 2014, economists are even more divided about the effectiveness of Keynesian macroeconomic policies and the broader role of government intervention in economic management. There is no "pure" market economy in the world of 2014. There is a role for governments in any economic system to limit economic cycles and financial crises, to enhance growth, to develop a social safety net, and to safeguard the interests of future generations, interests that include preservation of the environment and provision of the social and legal infrastructure for efficient operation of a market system.

The Islamic economic system is a market-based system, where markets are seen as the best and most efficient mechanism for resource allocation. But valuing markets for their efficiency is not the same as upholding markets as an ideology and a philosophy. The foundations of the Islamic economic system were laid down in the Quran and practiced by the Prophet Muhammad (sawa) in Medina. These rules that were established by the Almighty are the basis for the Islamic system and provide the effective institutions for the ideal Islamic system.

## KEY TERMS

Economic systems
Demand management
Markets
Institutions
Traditional economies
Market economies
Mixed market economies
Mixed socialist economies
Command economies

## QUESTIONS

1. What is an economic system, and what are its component parts?
2. What is the function of an economic system?

3. What is the role of government in different economic systems?
4. What would happen to economies if governments did not exist?
5. What are the key features of the Islamic economic system?
6. Would you rather have the Islamic or the market capitalist system in your country? Explain your answer.
7. How does the role of markets vary in different economic systems?