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The Economic Growth Imperative within Capitalism and the Islamic Viewpoint

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Introduction

There has been much discussion during the on-going financial crisis, on how to initiate a sustained recovery and the consensus shown by the mainstream commentators has been through returning to sustained economic growth. Such is the focus in the capitalist order towards growth, that any program or strategy that is not able to demonstrate how compounding levels of growth can be achieved is not given credibility and hence many, such as the Turkish economics professor Timur Kuran, have written extensively showing how the Shariah has rules which limit the ability of economies to grow and hence are an impractical alternative to the current order. It is the aim of this paper to demonstrate that the current capitalist economic paradigm with its fractional reserve banking model has within it a destructive growth imperative which is on an unsustainable trajectory and to present Islam's alternative approach to the subject.

What is economic growth and how is it measured

Economic output is the volume of goods and services produced over a financial year. The measure is called GDP or Gross Domestic Product. Other measures such as the Gini Coefficient have been developed to measure the distribution of wealth among the population. A coefficient of 0 suggests a completely even distribution and 1 suggests totally uneven distribution where a small number of market participants own the majority of wealth. It is worth noting that this figure is moving towards 1 in the states which adopt the growth strategy and is something the Occupy movement has tapped into.

The disruption in continual growth in output for 2 successive quarters is defined as a recession and this is regarded as a severe harm to the economy necessitating economic management to minimize the duration of the slowdown in output. This is the essence of the business cycle which is the alternating phases of growth and contraction which have been witnessed for hundreds of years under capitalism.

What then are the stated outcomes sought from economic growth?

According to all mainstream schools of Capitalist economic thought, growth in production is the solution to the fundamental economic problem facing society due to the coupling of the unlimited wants of man in relation to the limited resources available to satisfy such wants. This definition includes both needs and wants and not just basic needs.

The thinking of the founders of the first modern economic school of thought argued that increasing production was the key to maximizing happiness for the individual. Adam Smith, the founder of modern Capitalism, considered that if the society focused on maximizing production, this would equate with distributing wealth to the greatest number of individuals. His focus was not on targeting distribution as he felt that distribution would be a natural by-product of materialistically driven individuals all seeking their self-interest. In his book "The Wealth of Nations" Smith quotes: ***"By pursuing his own interest he frequently promotes that of the society more effectually (sic) than when he intends to promote it".*** Soon it became clear that the unregulated free market approach of the Classical school of Adam Smith was good at increasing production but deficient as far as the distribution of the gains of higher rates of production.

he next development was the neoclassical school, which emerged at the end of the 19th Century, proposing new ideas relating to value. As far as the breakthrough in the view of value and exchange, its input was to bring in a more accurate way of price formulation as far as considering both demand and supply and at the micro economic level. This had some positive impact on wages being more likely to be linked to the value that the labourer's service provided, however no distinct policy changes were associated at the macro-economic level with the emergence of the neoclassical school as far as formal re-distribution of wealth.

Since then, new thinking came in the latter part of the 20th Century through works such as the 1956 book entitled 'The Future of Socialism' which argued for a new way of breaking the disparity between rich and poor by not focusing on the size of the slice but the size of the pie. The argument being the same slice of a bigger pie would give more wealth to the less privileged classes.

We shall now turn to a discussion on the schools of modern capitalist economic thought relating to growth and demonstrate the single minded attitude of the mainstream approaches towards endless and exponential growth. These schools fundamentally differ over key factors that hinder growth through the mechanics of what is called the business cycle. It is of no surprise that much focus is thus placed on the business cycle by all capitalist schools of thought. A key argument is that if a theory can help minimize the slowdown in growth that occurs during a downturn in the business cycle, its policy proscriptions should be adopted by nations seeking endless growth.

However there are some non-mainstream schools, which reject the paradigm of growth. Rejection of growth as an endless strategy was in fact advocated by the mainstream schools including Adam Smith himself and Keynes given the obviously limited capacity of the earth to sustain growth indefinitely. Renewed interest in this area was spurred by a study by a think tank called Club of Rome whose study in 1972 called 'Limits to Growth' argued that the ecosystem imposes limits to growth. From this have arisen branches such as those who argue for a steady state economy that plateaus after a period of exponential growth, and Welfare Economics who differentiate between good growth and bad growth, the latter being termed uneconomical growth. More extreme movements have also arisen such as the De-growth movement who argue for downscaling production. However these are considered fringe ideas and we now turn to the mainstream view which advocates continual growth.

Current Approaches to Economic Growth

The main schools can be broadly grouped into the following camps:

1. Classical
2. Keynesian
3. Neo Classical which includes Monetarists and Rational Expectations
4. New Keynesian/New Classical

The formulation of the classical school as stated was the overwhelming belief in the efficiency of free markets to self-regulate themselves. It was felt that the laws of supply and demand were sufficient to ensure the allocation of resources would always flow to the most worthy projects and temporary gluts would be short lived as unemployed workers would easily accept lower paid jobs to regain employment.

It became clear very early on that in reality many market imperfections would act as impediments to this idealistic model and some type of interventionist approach by the state would be required to ease the market mechanism along to achieve this level of efficiency. Such intervention takes the form of monetary and or fiscal policy as the primary means of perpetuating the boom phase and minimizing the bust phase of the business cycle.

The period from the work of Adam Smith in 1776 with the publication of his famous book "The Wealth of Nations" to the onset of the Great Depression following the 1929 stock Market crash in the US was the golden era of the neoclassical school which deemed there to be a minimal role for the state. It became clear after a short while that the market was unable to recover by itself and needed active governmental efforts to kick start a recovery.

Prices were declining and unemployment was rising and the market was unable to self-correct from this situation. The saviour was the British economist John Maynard Keynes who entered the debate with his influential book "The General Theory of Employment, Interest & Money" published in 1936.

The central concept from the work of Keynes was that markets when in a downward spiral would not recover and the government needed to act as a catalyst to reinvigorate demand for goods and services through increased spending when the private sector was saving. This would however increase government deficits, nevertheless the argument was put that when times are good, taxes could be used to pay for such emergency spending for when times are bad.

This approach, adopted by the 1933 Roosevelt administration, was so instrumental in ending the Great depression that Keynes ideas ruled supreme until the 1970's when new phenomena called stagflation baffled economists on both sides of the Atlantic. This reality threw into question the policy proscription devised by the Keynesian revolution and the new saviour was the Chicago School economist named Milton Friedman whose ideas formed the Monetarist school which remained popular from the late 70's until the high inflation induced after the end of Bretton Woods was reigned in.

Stagflation saw the simultaneous upward climb of unemployment and inflation. Prior to this, as depicted by the Philips curve, there was always perceived to be an inverse relationship between the two where governments could bring down unemployment at the cost of some inflation and vice versa. As far as unemployment and the supply of money, if there is inadequate money in circulation to sustain trade requirements, then traders will be unable to trade at current prices as they lack the means to conduct their transactions. This would cause unemployment as traders would be unable to trade and be forced to start laying off staff due to the lack of sales for their production.

Therefore Friedman argued that the supply of money should be kept at an optimal level to avoid either extreme. Furthermore, he advocated that there was a `natural rate of unemployment' which the government shouldn't take action to reduce and instead the government should try to control the money supply so that it was in line with the level of economic activity. This theory was implemented through aggressively raising interest rates to soak up the excess money supply which brought the hyperinflation of the 1970's to an end.

Other schools such as the Rational Expectations School lead by Robert Lucas came to prominence since the mid 1980's that added that people could no longer be tricked by the government policy tools and that they would anticipate the actions that the state's economists would try to do and by so doing would be able to negate the intended aim of such governmental policies. For example when the government would increase the money supply economic agents would tend to bargain for higher wages ahead of time and firms would increase prices, so the effect of lowering unemployment which would otherwise have occurred, is not realised.

This insight was not new in that Friedman also used expectations to explain stagflation by arguing that economic agents anticipate the actions of the government when the government increase the money supply and the effect of lowering unemployment does not occur as economic agents would tend to bargain for higher wages ahead of time and similarly firms would increase their prices ahead of time and this would fuel inflation above the level intended by government policy and hence would render the attempt to reduce unemployment ineffective. Regarding the development in ideas related to rational expectations, both Keynesians and neoclassical schools reinvented themselves with new and post prefixes.

Other schools such as the Austrian School are variations of these themes and more recent contributions have come from what is known as behavioural economics which try to incorporate the physiological disposition of individual behaviour to explain the un-coordinated and often irrational behaviour of economic agents which prevents markets behaving in an optimal self-adjusting manner.

The final question to ponder is the issue of what the Policy differences are between the major schools. The preceding discussion is quite abstract as far as how theorists such as Keynes and Hayek, who is popularly characterised as the extreme end of the spectrum of mainstream thought, see the economic fundamentals necessary to prolong boom and minimise the bust phase of the business cycle. As far as policy, this difference manifests in the form of monetary and fiscal policy and which instrument is favoured to help return an economy that was in growth, towards growth in a downturn.

Other ways of framing this difference are also well known such as big government vs. small government or whether to regulate or 'get out of the way of business' a game cry of the right popularised by the 'tea party movement ' in the US. Ultimately these labels all point back to the fundamentally different views presented by the schools mentioned above.

Monetary and Fiscal policy intervention mask Market Failure in the Capitalist Model

What the brief historical analysis demonstrates is the single mindedness of the mainstream and heterodox schools towards seeking growth albeit through some variation of two principle economic levers being monetary policy, including its non-conventional forms such as quantitative easing or expansionary fiscal policy

None of these schools however demonstrate any profound understanding of market failure and therefore rely on trying to treat the effects rather than eliminate the cause. As a result the growth paradigm is not met with any credible alternative in the mainstream discourse and growth as an imperative to keep the system afloat is treated as the only option.

As evidence of this inability to remain immune from market failure, even with the slightest disruption to growth, the effects are severe and massive intervention or patchwork is needed to prop the frail system up for a little while longer. This delays the moment of reckoning for economy which when governed along these lines, is on an unsustainable trajectory as the finite resources of the earth are a limiting factor to endless growth. This was clearly demonstrated in the 1972 study called 'Limits to Growth' mentioned above.

This is not a justification for the Islamic Economic system not having at its disposal the lever of monetary policy due to the currency model being Gold and Silver based. Neither is there much scope for fiscal policy with the exception of emergency taxation (with restricted limits), so neither does there exists any mechanism for Keynesian based deficit spending or stimulus programs as we know them.

Fundamentally, market failure explains why economies are unable to deal with falling or stagnating levels of GDP. When these failures affect the micro economy, the result can be less economic trade and hence output, than would otherwise have been the case. Or the effects can be more serious such as an economy wide recession which we all know as a downturn in the business cycle.

The question being asked is whether these failures are inevitable features of free market activity or due to certain factors unique to Capitalism. If it can be shown that the Islamic Economic system can work in an expanding, contracting or stable environment as far as GDP is concerned, then it can be concluded that there is far less propensity to market failure and by extension there is no growth imperative in the Islamic Economic system being presented.

If we focus of four types of market failure, this will help answer these questions:-

1) Counterparty risk and price knowledge asymmetry
2) Destruction of competition and Monopoly
3) Trade restricting Regulation
4) Labour Market inflexibility

Let us consider each in turn:-

1) Trade that would otherwise happen often does not happen, as trading parties often do not have trust in each other. Furthermore when there is knowledge asymmetry as far as knowledge of fair market prices between trading parties, exploitation may arise. The building industry is a prime example were so many potential building contracts especially in the domestic sector simply do not happen as there is so much fear of unscrupulous builders in the industry. A similar argument applies to financial trade where central counterparties such as investment banks who were considered on the door of insolvency due to holding toxic assets on their balance sheets were no longer able to satisfy their role of being financial intermediaries or central counterparties to trade and hence trade suffered.

2) Smaller companies are responsible for the bulk of job growth. Despite the outwards appearance of diversity, behind the scenes company consolidation has been occurring and this has destroyed competition. As an example the computer networking company Cisco has bought out close to 200 companies since the early 1990s.(**1**) This is a negative development as new business growth and innovation in the private sector is key for new job creation. Innovation by small business has been replaced by the acquisition of innovating firms by large firms. This trend has virtually destroyed the potential for new start-ups to survive and create new jobs. Historically the trend for large scale production was to allow the harnessing of information that would otherwise be more difficult to obtain in a flatter market structure. Accordingly, information key to decision making and product development was channelled up to the highest levels within the organisation and back into the production process. This analysis follows the work of Ronald Coase in his 1937 paper entitled "The Theory of the Firm".

Now the potential to amass information exists without the macroeconomic baggage of large organisations so a fundamental rethink is required over why the economy needs such highly scaled up organisations. As far as natural monopolies where the argument is made that there is a need for large private sector companies via the PLC model to undertake the investment, these industries are publically owned in the Islamic model and run by the Islamic government on behalf of the public good. Fees can be charged for the upkeep of such services and this offsets the need for public wealth pooling via the stock markets.

3) Two aspects of regulation work as a significant means of market failure in Capitalism. Firstly regulation that is on balance useful in protecting the less powerful often gets bypassed through loopholes and other legislative oversight and secondly much regulation is hijacked by powerful economic actors and used to penalise the weaker market players, for example creating barriers to entry, resulting in it becoming a big impediment to growth and the development of trade.
Taking the first point, in the Secular marketplace, the disposition of market participants is to maximise profit as a means and an ends and this places them in direct confrontation with regulatory frameworks which are designed to protect all market participants especially the more vulnerable. As evidence of this, one needs to look no further than the amount of financial innovation being targeted towards bypassing financial regulation. For example the Repo 105 fraud undertaken by Lehman brothers (**2**) to conceal the bankrupt state of its Balance Sheet allowing Lehman brothers to take on more debt and risk exposure.
As for the second problem, countless examples exist of how regulation is devised to aid the powerful by for instance creating barriers to entry into the marketplace for small start-ups that help consolidate the power of the few firms that become dominant in the market.(**3**) This leads to an obstacle to new job creation and lost demand as there is less diversification and competition needed that would have helped create more employment and stronger aggregate demand which fosters trade in a market less prone to market failure.

4) Labour market inflexibility is another major impediment to achieving sustainable growth. When the economy is in recession, firms usually fire workers rather than drop salaries to the level they can afford. This increase in unemployment results in less demand which causes further layoffs as products are not being sold. In an efficient labour market, salaries and wages would need to fall until all workers could be employed and the market would clear i.e. surplus labour would be allowed back into the labour market. Due to factors unique to the Capitalist models, this failure is inbuilt into the workings of markets and the recessionary phase is needlessly prolonged and the impact on growth which benefits all citizens is severe and avoidable as will be made clear in the Islamic solution section.

The unique factors referred to above include, but are not limited to, the following:-

- Constant fear of monetary inflation which isn't a reality under the Islamic based Gold and Silver currency.
- Employer fear of workers sabotaging production associated with worker grievance when wages are reduced. When the mind set of citizenry is changed from the utilitarianism advocated by the champions of Capitalism such as Smith and Jeremy Bentham, for accountability to a creator of mankind namely Allah (SWT), the potential for this behaviour is significantly minimised and hence less of a factor under the Islamic model.
- Money illusion is a phenomenon that leads workers to see the nominal wage above the real wage and this fuels the reluctance to accept lower wages despite the lower wage having the same purchasing power and the overall positive effect on the level of aggregate demand in the macro economy associated with a higher employment level. Money illusion is prevalent in all societies that see constantly rising prices as the norm with central bank intervention to avoid deflationary effects in the market. This is not the norm in the Gold Silver based system and the Islamic system is exempt from this phenomena.

The destructive Growth Imperative within Capitalism

The current model of economics in the secular capitalist tradition is not robust enough to tolerate periods of slowdown or reduction in growth unlike the Islamic model which can flourish in a deflationary and equity finance environment due to a number of unique factors. Another primary cause of this growth imperative is the fractional reserve based monetary system which imposes an imperative on the expansion of the M1 money supply so that debt service is possible on the current loans in circulation. In this monetary system, all money is loaned into existence and therefore all money exists as debt. Therefore the monetary base needs to constantly grow along with the underlying growth in goods and services so as to avoid rampant monetary inflation when the money supply outstrips the growth in goods and services, and to meet interest payments, or a debilitating deflation when the money supply fails to grow in the form of new loans. This deflation is debilitating under the Capitalist system due to certain factors unique to it such as the fact that monetary policy becomes ineffective when prices are declining as low interest loans intended to increase the money supply are unattractive when prices are falling and the low interest rate cannot offset the inflating money. Also debtors are penalised in a deflationary climate. The former is not a reality and the latter as shall be shown is less of a concern in an equity financing environment unlike the debt based finance model prevalent in Capitalism. Therefore to avoid a deflation, there must be a constant increase in money supply and a corresponding increase in production. The final argument of the anti-deflation camp is that deflation causes consumers to delay purchasing goods and this leads to contraction. This view is not held by all the Capitalist schools, for example the Austrian school is pro-deflation. This argument fails to convince when one considers the growth in industries that have seen falling prices over the last few years such as the TV industry. Furthermore the question of whether consumers would delay the purchase of goods when there is the equal possibility of their wages deflating prior to their intended purchase, rules out any positive correlation between deflation and a downward spiral in economic transactions.

This race to produce more than is needed, under the umbrella of consumerism, as started by mind manipulators such as Edward Barnays and his 'Torches of Freedom' campaign, ensure that the practice of endless consumption endures. Furthermore practises such as 'planned obsolescence' where time bombs are built into products so as to ensure consumption and demand is constantly being recycled to sustain the fragile system, become the norm as far as manufacturing methodologies. This is very destructive as far as the Earths finite resources and is tantamount to stealing from the future to consume irresponsibly in the present.

In contrast, the Islamic model is immune to the effects of crazed consumption and deflation and is thus immune from the growth imperative. The Islamic economy can yield output at variable levels to achieve the objective of providing the necessary goods and services for its citizens in a much more robust and independent way.

Islam's vision regarding Growth

Measurement of the economy in Islam is not driven by empirical measures such as growth, rather the purpose of the economy is to meet certain inalienable rights (including food, shelter and clothing) and enabling individuals and companies to flourish within a comprehensive and stable regulatory environment according to the Shariah law. Muslims have an obligation to implement Shariah law within the Islamic state and an examination of the Shariah with respect to economy indicates factors highlighting its suitability in engendering growth, although growth is not the objective of the Shariah.

With debt and off balance sheet liabilities spiraling out of control in western economies (**4**), a return to growth is seen as essential, not only to generate tax revenues to pay back loans, but also to restore growth in employment. But, with the economy so beholden to the finance industry – whether via expensive bailouts or protective legislation – and with the banks sitting on cash to bolster their weakened balance sheets, there is a significant drain on the economy (**5**). The only solution put forward has been a toxic mix of money printing and austerity. There is another way. To encourage public investment back on track requires an environment in which spending and investment is encouraged. Islam tackles this in two ways. Firstly, by removing all interest based investments, and coupling that with laws preventing the hoarding of wealth/money, society will naturally seek returns on capital via business investment. Consequently, the Islamic company investment market in an Islamic state is very vibrant and participants share in risks and rewards with investment dependent upon actual participation in the company rather than anonymous "trading" in/out as espoused by western markets. A second key element is the taxation system which taxes heavily un-invested capital, providing another incentive for full investment.

Core characteristics of the economy within the Islamic State includes a stable currency based on gold and silver bullion, no interest allowed on any transaction, prohibiting the hoarding of wealth coupled with wealth based taxation and equity/partnership rather than debt based financing. Of great importance is circulation of wealth amongst all in society, with incentives for investment and strong dis-incentives for hoarding maintaining the momentum and velocity of the economy. ***"In case it (wealth) circulates solely among the wealthy from amongst you." [Translation of the meaning the Quran surah Al-Hashr, 59:7]***

Strategic Growth Advantages of the Shariah

12 distinguishing characteristics of Islam with respect to growth:

1) Gold/Silver based currency

The currency is fully administered and managed by the State treasury (Beit al Mal). The state is obliged to back 100% any issued currency notes (with physical gold and silver) – no fractional banking is tolerated by Shariah and gold/silver reserves are fully open to public audit. As a consequence fractional reserve banking is not allowed within the state and no growth of money (open market money creation) via banking groups or the state is tolerated. Money is treated as a medium of exchange and consequently is not a monetary tool for banking interests. With monetary supply dependent upon wealth within the state, currency induced inflation is minimal and cannot reach levels seen during the 1970's for example when the US took the world unilaterally away from the gold standard in 1971. Historically the level of inflation and deflation under the gold standard was low and within a 2% variation (not more than 2% inflation or deflation) (**6**)

Maintaining currency stability and the absence of high levels of inflation is a key requirement for business (**7**). The volatility of fiat/paper based currencies, particularly where governments engage in aggressive monetary easing due to excessive spending runs directly against the needs of business.

Inflation from the viewpoint of price instability, is harmful as business proprietors cannot calculate prices and hence do not undertake investment given uncertainty towards costs, sale prices and profitability. Under the gold standard, prices are more stable over the long term leading to a more stable environment for investment decision making. Businesses struggle to plan and gain investment within high inflation environments.

The passing of power to central banks to enable manipulation of the money supply in recessionary times risks uncontrollable inflation. The recessionary business cycle in which a fiat currency/fractional reserve banking environment is a factor through inflation risk, adds to business uncertainty and can delay the growth cycle (**8**). Lastly gold and silver is the ultimate currency and physical gold and silver (not paper based investment products) have no counterparty risk.

2) Non Interest Economy

Islam forbids all usurious (interest) based transactions.

"Whereas Allah has permitted trade but forbidden usury (interest)" **[TMQ Al-Baqarah 2:275]**

The provision of interest across most financial transactions acts as a form of taxation, it is an additional cost and consequently is a drag on profitability, investment and growth. Rather than equity/partnership based investment the interest/debt model popular in western economies has meant that banks and finance providers can not only create money from nothing (fractional reserve banking) but can charge interest (expense). Furthermore via collateral lending, lenders can guarantee virtually risk free returns via the requirement for valued assets to be put up as collateral against non payment of principal and interest.

As all fiat money exists as debt, then the need for interest payments on debt necessitates an ever increasing expansion of the money supply to keep the system afloat. This drives a corresponding increase in the growth in the production of goods to avoid hyperinflation resulting from too much money in relation to goods. In the ten years prior to the financial crisis of 2008 over 100 Trillion dollars of money (debt) was created (**9**), the deleveraging of this debt is continuing to this day and acts as an anchor against economic recovery and growth.

The enabling of banks to set interest rates and then bet on the movement of such rates is manipulative and runs counter to the notion of open markets. The LIBOR (London Interbank Offered Rate) scandal highlighted the damage caused to market confidence and the record levels of fines (**10**) indicated the seriousness of this damage. Such manipulation of markets is not possible where interest in all forms is forbidden.

Despite steadily decreasing interest rates in the Japanese economy - an indication that policy makers recognise that interest is injurious to growth - growth has been been elusive over the past 20 years (**8**). Current attempts by the US and other central banks (for example the UK) to steadily reduce interest rates to generate growth through lowering the costs of borrowing clearly show that interest is costly to the economy. It is strange that governments now are close to a zero interest rate policy – given to some banks – whereas a zero interest rate policy for all borrowers is not adopted.

Having brought significant numbers of investors into government bond markets who depend upon interest to provide investment returns including significant pension assets, those investors are now suffering with tiny returns as interest rates have been reduced to close to zero for government bonds (and are less than inflation – negative real rates). Current typical asset allocation for pension funds is 40% invested in interest bearing securities (**11**). Gillian Tett, deputy editor of the Financial Times called this "financial repression" against these bondholders (**28 Jan 2013 Newsnight, BBC**). If the whole system was based upon equity/partnership returns rather than interest as advocated by Islam, then the consistency of investment approach would provide greater certainty and stability based on business profitability rather than variable interest rate returns.

3) No hoarding of wealth

A key element of financial management in Islam is the requirement that wealth is not hoarded. ***"And those who hoard gold and silver and do not spend them in the Path of Allah then announce to them a painful torment"*** [TMQ 9:34]. With interest based economies and the associated bust and boom cycle means, wealth is alternately readily available for investment in times of growth and withdrawn from investment in recessionary times.

A consistent environment for growth in the economy requires a consistent flow of wealth into the economy for investment. The interest based banking system is dominated by banks which provide liquidity when it suits them and withdraw capital when deleveraging as in the current cycle. When felt not to be profitable banks will not lend money and this forms obstacles to the circulation of wealth and a return to growth in the economy (**12**). Furthermore, taking money out of circulation leads to a heavy taxation penalty upon the perpetrator.

*4) **Taxation policy***

Islam maintains a wealth and productive capacity of the land based taxation system which encourages full investment and a rapid circulation of wealth. The plethora of taxes imposed on the public in western economies is a great oppression. Islam has a simplified approach, which is predominantly based on wealth as opposed to income tax. By focusing upon accumulated wealth which is not invested (*Zakat* at 2.5% per annum), taxes on the productive capacity of the land (*Kharaj*) and head taxes (*Jizya*) for those who can afford them, the State is encouraging work/enterprise and investment, and discouraging the withdrawal of wealth from circulation, exactly the conditions which bank/debt dominated western economies are suffering most from. Inevitably, the consequence is a smaller footprint for the state which coincides with the general perception that governments in the western world have taken on too much responsibility (and high budget deficits) and are stifling recovery with ever higher taxes—taxes which fall unevenly on the poorer via income and consumption taxes.

With little or no disincentive from taking wealth out of circulation, banks, large corporations, and wealthy individuals will hold onto wealth and perpetuate the dis-investment cycle. Contraction in business, fewer jobs and further declines in government taxes results.

5) Equity/Partnership rather than debt based financing

Capital markets in the Islamic state are dominated by partnership and company formation in which the key features are: offer and acceptance, defined profit and loss sharing between investors/partners, a specific corporate body (not anonymous share ownership), and no limited liability. Additionally there is no organised share trading market (stock market), as transfer of ownership must be agreed between owners on a case by case basis. As a consequence the ownership and management of companies is tightly controlled and all partners/investors have specific responsibilities rather than the often anonymous and opaque ownership structures in western markets (**13**).

Whilst large companies can form under Islamic company governance rules, most of the largest projects including management of public resources such as oil, gas, water and electricity are administered by the state. With no corporation tax or business taxes and only zakat payable on certain of the business inventories (including livestock) there is no little incentive for business formation and growth. The requirement for all partners/owners to agree in the formation, objectives, profit disposition and other major decision making ensures direct accountability and closer association with the running of business, rather than that detached ownership model driven in the secular stock markets, where employees (company Directors) can take decision largely separate from day to day review and the active oversight of shareholders.

6) Absence of limited liability

Leading to more measured risk taking. A necessary requirement for all company formations in Islam is the existence of partners/owners who take full responsibility for all transactions/contracts entered into. Losses are apportioned to partners/owners in the proportion of capital invested in the business. This contrasts with the excessive risk and borrowing approach adopted by the large Wall Street banks. Large Wall Street banks who regarded themselves as 'too big to fail' i.e. operated with the knowledge that their liabilities would be covered by the taxpayer in order to avoid systemic collapse. At the height of the financial crisis large US banks balance sheets were more than 40 times levered (**14**). Shareholders are not technically responsible for all commitments of these companies with limited liability.

The consequent bailouts of these banks have placed immense burdens upon taxpayers and the economies of these western countries. Bailouts in the UK alone have amounted to more than £1.2 Trillion greater than the size of UK yearly output (**15**). Under Shariah the State and its leaders are not authorised to bailout any failed companies.

7) Gambling is prohibited

No Derivative or virtual economy leading to massive volatility in financial markets and which have spilled over into the real economy. Much of the need for many of the financial products that act as insurance to the volatility of the current economic approach is negated as the same degree of uncertainty does not exist with the Islamic economy.

The role of Goldman Sachs in the problems of Greece is adequate to demonstrate how such manipulation is possible through the use of these complex financial instruments that often beat the ability of regulators to understand in time. (**16**) Gambling and derivative contracts also add nothing to the economy but heightened counterparty risk. As winning and losing bets are between respective parties it is often felt that the economic impact is neutral, however the counterparty risk of a bank failure, and an attendant domino collapse was highlighted at the time of the collapse of Lehman brothers in 2008. The taking on of risk equal to more than 20 times the size of the world economy owes more to a drive to earn greater fees and earnings rather than a reduction in risk. One commentator likened the market to a 40 pound flea on the back of a 4 pound dog, with the dog now dying. (**17**)

8) No intellectual property rights

Rapid technological innovation with improved distribution. It is argued that intellectual property i.e. patent protection is vital to create entrepreneurial drive, as without knowledge protection, there is insignificant incentive to develop innovative productive science. In Islam knowledge is purchased along with the purchase of the good or service as far as this knowledge can be obtained. This means that many firms can develop on existing knowledge and bring the new innovations to market quickly, leading to rapid increments to innovation. This approach negates some of the limitations in development of commercial projects on the same scale as the capitalist PLC companies. (**18**)

9) Flexible labour markets where wages are able to adjust to deflationary environments

Efficient markets due to sound concepts of value and *Rizq* (God given provision). A significant factor in explaining why recessions occur is due to market pricing failure. Employers do not drop wages and salaries to levels necessary to ensure that they can keep their existing staff employed. Instead they prefer to preserve fewer staff at current wage levels. However this increases unemployment and is very damaging for the wider macroeconomic environment due to a decrease in aggregate demand at current price levels.

The reason why dropping prices or deflation is considered a great evil under Capitalism is due to unique factors which do not exist in Islam. Firstly, monetary policy becomes ineffective during deflationary times as banks would need to pay interest on the loans they issue to incentivise borrowers to borrow money, which means borrowing declines and monetary policy becomes ineffective. Secondly, existing debtors are penalised in deflationary environments as the value of their debts increase in real terms. This reality also does not exist in Islam as borrowing is not the norm instead equity investment is the prevalent mode of finance.

Money illusion is additionally a key reason why workers are averse to pay cuts despite their not being any worse off in real terms as lower wages in an environment where prices are falling does not equate with a lower standard of living. In this regard, the Capitalist theorists failed to capture the real essence of the meaning of value as far as separating it from money as a gauge and this has led to a disconnect from seeing value, in this case the value of wages, away from the prism of the nominal amount and hence this irrational attachment to the nominal amount of wages and salaries being the paramount consideration in wage negotiation. Furthermore the fear of monetary inflation is never far from the fear of deflation and this further de-incentivises workers from accepting pay cuts.

As these factors do not exist in the Islamic model, there is no reason to suspect that workers will be averse to having flexibility in wage negotiation and hence offers a much more versatile and robust feature to the economy.

10) Land reform

The Quran stresses: ***"In order that it does not make a circuit between the wealthy" [TMQ Hashr 59:7].*** The aggregation of vast land tracts into the hands of a few has led to widespread poverty amongst the masses. In the US, 15% of the population now depends upon food stamps for basic food needs. Land ownership in one of the largest and most fertile countries in the world is but a dream for most, as it sadly is in most of the Muslim world, as Islamic law is not currently applied. Shariah law in this regard is very dynamic and enables widespread ownership amongst the many. If land is not utilised for a period of 3 years, it reverts to the State and will be re-allocated to those that will use it. Any member of the public can claim dead or unused lands, and leasing of lands by those that cannot utilise it directly is forbidden. This coupled with strict restrictions against any form of price fixing translates into dynamic land utilisation and far wider participation in the core wealth of the land.

11) Ethical trade and trader rights

In Islam, there are numerous rules and provisions which ensure traders feel confident that either contracting party will not be subjected to any form of exploitation and in the event that this has happened, to have fair and decisive redress in the form of annulling of the contract. Therefore market failure due to knowledge asymmetries is not a reality in Islam.

Furthermore the Prophet said as narrated from Muhammad ibn Yahya ibn Hibban: **"If you purchased say there is no deception, then in every commodity you purchased you have the choice after three nights to accept (the commodity) and thus hold it or to return it back to its owner."**

This is conditional of their having been ignorance on the part of the buyer or seller as to the market price and the deviation from the market price being excessive. Under such an environment, traders will be more forthcoming to trade, knowing that a fair mechanism to seek redress exists. Trade can be expected to flourish under such a business friendly environment. This is just one example of the rules, further examples of the business friendly principles can be found on page 22 of 'Economic Thought of Al-Ghazali' by S. Mohammad Ghazanfar and Abdul Azim Islahi.

12) Regulatory framework In Islam

Regulation in Islam aims to foster a safe and productive environment where wealth that is generated can be more equitably distributed than the current Capitalist economy. It is not a means of creating entry barriers for small business or allowing favours to be granted by the political structure in response to lobbying and other underhand means.

One may argue that the goals of regulation, namely to curtail open trade, are inherently in conflict with the goals of traders who are profit seekers and as such they will always have a limited ability to achieve their desired aims. In Islam, as wealth procurement is not the ultimate aim in life, as is earning the pleasure of Allah, such frictions have no reality as both the wealth and the means to obtain it lie firmly under the domain of the individuals desire to adhere to the Shariah rules which manifest this goal in life.

As far as the second concern highlighted above, there is no possibility of lobbyists creating a biased agenda for regulation to protect the few dominant players as the rules are clearly defined by the Shariah rules. Furthermore many rules are aimed at aiding traders to enter markets to create a healthy competitive environment for sustainable growth unlike the regulations which penalise small businesses and lead to substantial barriers for entry. (**19**)

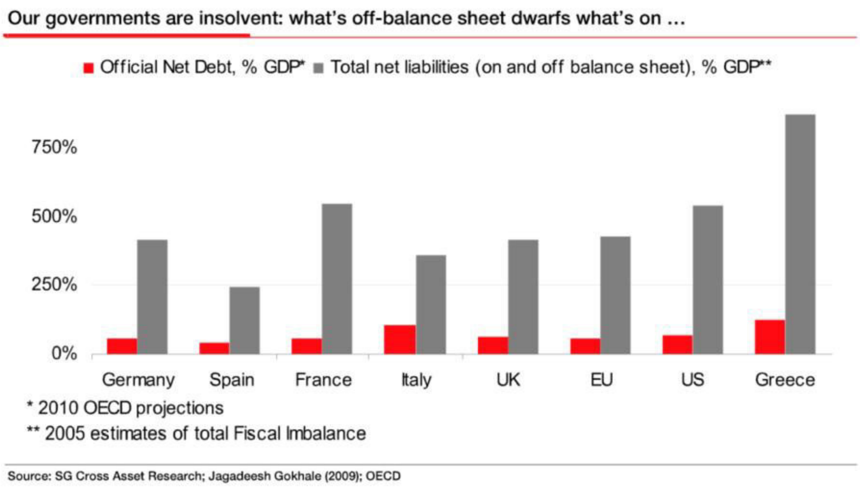
Conclusion

There is a growth imperative within the capitalist solution and this permeates all mainstream Capitalist schools of thought. This growth imperative is leading to an implosion of the current system given the finite and rapidly diminishing resources of the world, which are to be used to try and meet the demands of compounding interest and ballooning derivatives gambling. The world is ready for an alternative root and branch vision based on the unique solution offered by the Islamic alternative and it is the aim of this document to start laying the framework for the debate so that one can enter it with effectiveness.

This alternative will show how the economy should function and grow through sustainable practices so as to attain a more equitable distribution of wealth. It will offer an approach with the correct balance of savings, investment and consumption to achieve real wealth for all. The Islamic economy is not founded upon forced re-distribution of wealth in efforts to drive some form of equality, nor completely un-regulated markets where strong corporate interests can dominate the economy. The Islamic economy focuses upon a clear and consistent set of rules which are consistently applied across society. The emphasis is upon ensuring ownership of land far and wide and low tax to encourage spending and investment. The results throughout history of the Islamic State (Caliphate) has been one of widespread circulation of wealth to ensure all can benefit from it, rather than a divisive accumulation of wealth in the hands of the few.

Footnotes

(1) http://en.wikipedia.org/wiki/List_of_acquisitions_by_Cisco_Systems
(2) http://www.guardian.co.uk/business/2010/mar/12/lehman-brothers-repo-105-enron
(3) http://www.ij.org/city-studies-on-barriers-to-entrepreneurship



(4)
(5) http://www.guardian.co.uk/business/2012/sep/16/vince-cable-new-bank-truth-lending-failing

(6) http://www.thegoldreport.co.uk/publications/gold-standard-the-future-for-a-stable-global-currency (pages 9 and 10)
(7) The Inflation Tax in a Real Business Cycle Model, Cooley and Hansen
(8) Are we the next Japan? http://money.cnn.com/2011/09/27/news/international/US_Japan_recession.moneymag/index.htm
(9) ATCA, Asymmetric Threats Contingency Alliance http://www.siliconvalleywatcher.com/mt/archives/2008/10/the_size_of_der.php
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(14) http://blogs.reuters.com/bethany-mclean/2012/03/19/the-meltdown-explanation-that-melts-away/
(15) http://www.guardian.co.uk/news/datablog/2011/nov/12/bank-bailouts-uk-credit-crunch
(16) http://www.spiegel.de/international/europe/greek-debt-crisis-how-goldman-sachs-helped-greece-to-mask-its-true-debt-a-676634.html
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(19) http://www.management-issues.com/2006/8/24/research/a-good-place-to-do-business-but-too-much-red-tape.asp