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BETWEEN FREE MARKET AND STATE CAPITALISM: HOW ISLAMIC ECONOMICS SYSTEM SHAPE THE FUTURE GLOBAL ECONOMY?[*]

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ABSTRACT

Free market economy is proposed to deliver on the promises of improving the standards of living of most citizens. However, the economic crisis that happen repeatedly failed to produce what was promised. Then, state capitalism has to step in. The state capitalism also fails in the sense that the free market economy with rules/policy in favour of rich countries or state capitalism provide more people worst-off than benefits. The question arises on how the Islamic economic system could shape the free markets and the future of the global economy. Therefore, our aim in this paper is to find out the answer(s) on how Islamic economics system shape the future global economy could. Our analysis shows that Islam has its own economic system. The free market could be developed by taking the free market of Prophet Muhamad (saw) and free market in holding wealth. The government policy directed towards no interest and creating a welfare system is welcome.

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1. Introduction

Free market economy is proposed to deliver on the promises of improving the standards of living of most citizens, hence all of the good things of companies (such as social responsibility), all of the social justices, the preservation to our environment, the empowerment of the poor, should be there. However, the economic crisis that happen repeatedly failed to produce what was promised, but it delivers on what was not promised – inequality, pollution, unemployment, and most important of all, the degradation of values (or ethical deprivation) where everything is acceptable and no one is accountable. It means that free market economy has not worked in the way it should and then government has to step in. It creates new mechanism known as state capitalism.[1]

The state capitalism also fails in the sense that the free market economy with rules/policy in favour of rich countries or state capitalism provide more people worst-off than benefits. It also create tool that can serve national interest better, or at least those of ruling elites, rather than as an engine of opportunity for the individual. It means that the benefits are on the state (or the elite community) but not on the individual. Therefore, the cost-benefits principle (which is one of the most important principles in economics) is crucial to the future of free market and state capitalism. We believe that it is not only cost-benefits per se because sometime benefits (*maslahah*) can only fall to individual which may bring harm (*mafsadah*) to the community. Related to this, I have been frequently asked with these questions. Is there hope for Islamic economics? Can Islamic economics be implemented? There is no easy answer to such questions, but clearly the first Islamic economic conference became a turning point.[2] After that, among the precipitating events were the establishment of first Islamic banks in 1975, i.e., Dubai Islamic Bank and Islamic Development Bank (the elimination of interest rate from banking system) and the re-inventing of socio-financial institutions (like zakat and waqf). The establishment of Islamic banks motivated other aspects in Islamic

[1] This new wave is known as twenty-first-century package.
[2] Refer to our book, Ismail and Choudhury (2014).

finance to flourish such as capital market (equity and sukuk markets) – to a point that sukuk markets over-taking bond markets. So, too, the increasing role of socio-finance institutions such zakat, wakaf, and other philanthropy tools are set to begin.

On the implementation of Islamic economics, it has been very much clouded in the financial sector. It should go beyond finance. In this chapter, we suggest free market with no interest and ethical elements, and combined with philanthropy that will achieve the welfare state. Why we say so that ethical aspects should be embedded in discussion about free market. Is our free market system separated from ethical values? Much of what has gone on (that contribute to the failure of free market) can only be described by the words "ethical deprivation." Something wrong happened to the moral compass of so many of the people working in the economic sectors and elsewhere. Free markets seem to have changed the people or individual who went to work at the Central Bank or highly paid companies were like most other individuals except that they did better in their schools.[3] It is not surprising that the list grievances against companies (such Enron, see The Economist (2002), American International Group, see Bloomberg Businessweek Magazine (2005)) is long and of long standing.[4] For instance, cigarette and liquor or casino companies made their dangerous and un-productive products and services, but they still try to persuade people that there were no "scientific evidence" of their products' dangers.[5]

The other missing points are the policy. The government policy shapes those market forces. Government has the power to regulate the markets. At least the policy makers are guided by a theory which is derived from revealed knowledge. At least, we believe it is part of our belief that interest rate should not be in anywhere in our economy, and philanthropy should be there. Hence, how will these shape our economy? Neither Islamic economics free market nor state capitalism. The free market is actually delivered on the promises of preserving the maqasid shariah.[6]

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[3] The Prophet (saw – peace be upon him) said: 'Among the Muslims the most perfect, as regards his faith, is the one whose character is excellent, and the best among you are those who treat their wives well.' [Al-Tirmidhi Hadith 628, Narrated by Abu Hurayrah]. It is *akhlak* (or ethics) which are considered the most perfect Muslim.

[4] Please refer to http://en.wikipedia.org/wiki/List_of_corporate_collapses_and_scandals, for a long list for corporate collapse and scandals.

[5] Refer to Surah Al Baqarah (2:219): "*They ask you about intoxicants and games of chance. Say: In both of them there is a great sin and means of profit for men, and their sin is greater than their profit. And they ask you as to what they should spend. Say: What you can spare. Thus does Allah make clear to you the communications, that you may ponder*."

[6] See Appendix A.

Therefore, the chapter is aimed to discuss the free market economy and how it shapes the free markets and the future of the global economy. The remaining discussion will be divided into six sections. Section two offers an explanation on the failure of free market economy that lead towards state capitalism. Section three will reveal how and why government in a different country use it. Section four will discuss the elements in both free market and state capitalism that are similar. Hence, in section five, we will argue that with a different element in Islamic economic system, it may shape a new dimension in the free market economy. Section six will conclude.

2. MARKET FAILURE AND ECONOMIC SYSTEM

Diagram 1 represents what we might call the market spectrum. At each end are the ideological extremes of a state's role in an economy. On the far left is utopian communism, with absolutely no free market activity. Like, a football game, the referees have absolute control of every player's move. This extreme has never existed, because even in the most tightly controlled state, black markets supply to meet demand like bad money chases good money. On the far right is utopian libertarianism, which some economists call free market anarchism.[7] At this extreme, there is no government and no other authority that can manage, regulate or interfere in any way with the operation of markets. It is a football game with no referee at all.

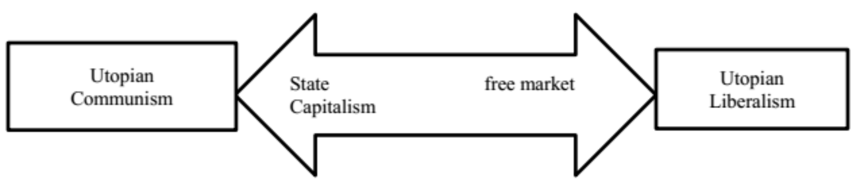

Diagram 1. Market Spectrum.

Between these extremes are real-world forms of capitalism, which include centralized economies with sharply limited free market activities on the far left and free market economies with minimal government involvement on the far right. Within this narrower spectrum, the economic system may vary depending on the government involvement in the workings of its economy.

[7] Free market anarchism is a political philosophy which believes the elimination of the state in favour of individual sovereignty in a free market system.

How do we know where any given country would fall along the line? Let we look at few example below. The Eurozone debt crisis that occurred in late 2009 was the result of the difficulties for some member countries to repay or refinance their government debt. In addition, banks in the Eurozone were under-capitalized and had faced liquidity problems.[8]

Table 1. Treasury Equity Investments as of November 10, 2008

Company	**USD Amount (Billions)**	**Company**	**USD Amount (Billions)**
AIG	40.00	KeyCorp	2.50
JPMorgan	25.00	Comerica	2.25
Citigroup	25.00	Marshall & Iisley	1.70
Wells Fargo	25.00	Northern Trust	1.50
Bank of America	15.00	Huntington Bancshares	1.40
Merrill Lynch	10.00	Zions Bancorp	1.40
Goldman Sachs	10.00	First Horizon	0.866
Morgan Stanley	10.00	City National	0.395
PNC Financial	7.70	Valley National	0.330
Bank of NY Mellon	3.00	UCBH Holdings	0.298
State Street	2.00	Umpqua Holdings	0.214
Capital One	3.55	Washington Federal	0.200
Fifth Third	3.45	First Niagara	0.186
Regions Financial	3.50	HF Financial	0.025
SunTrust Banks	3.50	Bank of Commerce	0.017
BB&T Corp	3.10		

Source: http://www.investopedia.com/university/credit-crisis/credit-crisis6.asp.

During the period of 2007-2009, the trend toward greater state power reached a leaning point. The global recession and financial crisis that happened in 2009 and 2008, respectively and the credit crunch of 2007, showed the political masters in both the developed and the developing countries seized responsibility for decisions that are usually left to market forces. For example, President George W. Bush signed the Emergency Economic Stabilization Act of 2008 (the “bailout plan”). With financial

[8] This has led to the incorporation of liquidity risk in Basel III.

market conditions continued to deteriorate, it prompted the Treasury to decide that it would be faster and more efficient to invest directly in companies as opposed to purchasing assets from their balance sheets. To that end, as shown in Table 1, the Treasury invested USD125 billion in nine of the largest U.S. banking institutions and made an additional USD125 billion available to smaller firms. The Treasury also received preferred stock in exchange for its capital infusions, with the expectation of being repaid in full, with interest.

Table 2. Announced Stimulus Plans (Q4 2008-Q1 2009)

Country	Amount US$ billion	% GDP	Country	Amount US$ billion	% GDP
Argentina	3.9	1.2	Netherlands	7.5	1.0
Australia	10.1	0.9	New Zealand	5.0	3.7
Austria	3.7	0.6	Norway	2.9	0.6
Belgium	2.5	0.6	Pakistan	7.6	1.9
Brazil	3.6	0.2	Peru	3.2	1.1
Canada	43.6	0.7	Philippines	6.1	1.2
Chile	4.0	2.2	Poland	31.4	5.5
China	586.0	6.9	Portugal	2.7	1.3
Czech Rep	7.8	1.9	Russia	20.0	1.1
Egypt	5.4	1.7	Saudi Arabia	126.7	3.4
Finland	2.6	1.7	Singapore	13.9	3.5
France	33.0	1.3	South Africa	3.7	1.2
Germany	103.3	1.6	South Korea	10.8	1.1
Hungary	6.5	4.0	Spain	113.3	6.7
Iceland	2.1	5.3	Sweden	1.0	3.0
India	4.0	0.3	Switzerland	1.3	0.3
Indonesia	6.7	1.3	Taiwan Province of China	12.0	3.0
Israel	5.0	2.7	Thailand	8.5	3.3
Italy	6.3	0.3	UK	36.3	0.9
Japan	110.0	2.3	USA	787.0	5.5
Malaysia	17.2	4.0	Vietnam	1.0	1.1
Mexico	11.4	1.0	Total World	2180.6	3.5

Source: Isabel Ortiz.

Other countries also announced the fiscal stimulus plans, as reported in Table 2. It shows the transfer of market power from capitals of finance to capitals of political power took place all over the world.

The savings-and-loan crisis of the 1980s and early 1990s shows that more than a thousand savings-and-loan associates failed at a cost of at least USD125 billion to the federal government. The same also happened during the stock market crash 1929.

The South Sea Company (founded in 1711), enjoyed a monopoly over British trade with Spanish South America and the Pacific region. Its share price rose 800 per cent in about six months in 1720 when holders of government bonds were offered swap shares in the company at discounted rates. The share then fell 90 per cent in the remainder 1720. It ruined many late investors.

The above examples show that there is plenty of corroborating evidences to show that the free market has failed. The evidences show that temporary surge of momentum via government efforts to ensure that it never happens again. This combination of free market and government intervention creates a "mixed" capitalist economy. There are variations within even this single category of capitalism, because some states involve themselves in their domestic economies much more often and more directly than others. Whereas, others believe that only free market can generate long-term prosperity and that government should never become the dominant player in an economy. Hence, state capitalism represents a direct challenge to that belief.

However, the economic crisis that happened around 1800BC, tells us a different story. As recorded in Chapter Yusuf, verses 42-48,[9] the Pharaoh of Egypt summoned Prophet Yusuf, then an imprisoned slave, to interpret two dreams. In the first, seven plump cattle were followed and devoured by seven lean, starving cattle. In the second, seven thin ears ate full ears of corn. After hearing these dreams, Prophet Yusuf prophesied that Egypt would enjoy seven years of prosperity, followed by seven years of famine. He recommended a consumption-smoothing strategy to provide for the years of famine, under which Pharaoh would appropriate and score a fifth of the grain produced during the years of plenty. According to the tafseer ibnu Khathir, Pharaoh embraced this plan, made Prophet Yusuf his finance minister, and thereby enabled Prophet Yusuf to save Egypt from starvation. According to tafseer ibn-Abbas, he elaborated further verses 46 as follows:

> When he went to him, he said: (Joseph! O thou truthful one!) O you who were truthful in interpreting the first dream, (Expound for us the seven fat kine) that came out of the river and (which seven lean) that were dying of lack of nourishment (were eating and the seven green ears of corn and other (seven) dry) coiling around the seven green ears, overshadowing their greenery, (that I may return unto the people) to the king, (so that they may know) the interpretation of the king's dream.

[9] Scholars, such as ibnu Khathir place the episode somewhere around 1800 B.C. See also Maurice Obstfeld and Kenneth S. Rogoff (1996).

> Joseph said: "Yes! I will interpret his dream. The seven fat kine are seven years of soil fertility, and the seven green ears represent abundance and low prices during these seven years. The seven dying, lean kine represent years of drought while the seven dry ears represent lack of foodstuff and high prices during these years."

While verse 47, ibn-Abbas mentioned that:

> Joseph then instructed them what to do. (He said: Ye shall sow seven years as usual) each year continuously, (but that which ye reap) of crops, (leave it in the ear) and do not thresh it, this is better for its preservation, (all save a little which ye eat) all save the quantity which you need for your sustenance.

He further explained in verse 48 that:

> (Then after that) after the seven years of soil fertility (will come seven hard years) seven years of drought (which will devour all that ye have prepared for them) all that you have saved during the seven years of soil fertility, (save a little of that which ye have stored) kept aside.

There are several lessons learnt from the above crisis. First, the rulers does not intervene and ask the farmers to sell the commodity and get some money (or the state can accumulate foreign reserve, if the commodity is for export) and save it for later consumption. Second, the policymakers prefer to persuade the farmers to store the commodity and ask the people to eat steadily as precautionary measure to overcome the recession. This might challenge to free economy and state capitalism, because there is no similar prescription and intervention as will be discussed further in sections three and four.

3. State Capitalism

The failure of free market (sometime it synonym with "too big to fail" hypothesis) marks the re-emergence of state capitalism in a twenty-first-century package.[10] Economists like Crouch (2005), Musacchio and Lazzarini (2012), McNally (2013) identify there are two fundamental differences

[10] Several economists argue that state capitalism existed before the industrial revolution i.e. before the end of the eighteenth century. It came under attack from Adam Smith, David Hume and others.

between free market and state capitalism. First, policy makers do not embrace state capitalism as a temporary series of meant to rebuild a shattered economy or to jump-start an economy out of recession. It is a strategic long-term policy. Second, state capitalists see market primarily as a tool that serve national interests, or at least those of ruling elites, rather than as an engine of opportunity for the individual. Normally, state capitalists use markets to extend their own political and economic leverage – both within society and on the international stage. It shows that the state dominates markets primarily for political gain, not to serve the public welfare. How does it actually work? Do they have tools to manage state capitalism? Generally, political leaders use a variety of market/intermediary institutions.[11] Among the most important institutions are national oil and gas corporations (NOGCs), state-owned enterprises (SOEs), privately owned national companies (PONCs) and sovereign wealth funds (SWFs).

There are companies like Saudi Aramco, Gazprom (Russia), CNPC (China), NIOC (Iran), PDVSA (Venezuela), Petrobas (Brazil), Abu Dhabi National Oil Company, Kuwait Petroleum Corporation and Petronas (Malaysia) are owned by state. They control about three quarters of global crude-oil reserves.[12] There are several factors that motivate countries to use the NOGCs as tool: (i) to limit the financial and political risks generated by rising oil and gas prices, although in late 2015 and early 2016 there was uncertainty in oil and gas prices; (ii) to reduce their dependence on hostile or potentially unstable energy producing countries; and (iii) to reduce carbon emissions to slow the process of climate change. More importantly, oil and gas are important commodities that will be fuelling the global economy for many years to come.

State-owned enterprises are considered an extension beyond the energy sector. In large or small economy in the world has at least a few. In Malaysia, the Postal Service and the Corporation for Public Broadcasting are all essentially state-run enterprises. State-capitalist governments also involve aggressively in industries like petrochemicals, power generation, banking, ports and shipping, automotive and heavy machinery, telecoms, aviation and food productions. Political leaders in state-capitalists use them for political power.

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[11] The state does not always exert day-to-day control, but is has considerable direct influence over these tools.

[12] Normally, we are exposed to the phrase "big oil" images of Western multinational companies like ExxonMobil, Royal Dutch Shell and British Petroleum.

National companies are entities that remain in private hands (though governments sometimes become the minority shareholder) but they rely on aggressive material support from the state to develop a powerful position in a domestic economy and its export market. Bidding on state contracts is often rigged in their favour. They also have access to cheap financing from state-owned banks, tax breaks from federal and local governments, and near-monopoly control of entire economic sectors. This is not a new phenomenon. In Japan, the creation of large integrated business groups called *keiretsu* was part of this state-capitalist. Companies like Mitsubishi, Mitsui, Toyota and Sumitomo were created to integrate all stages of the manufacture of single products or many different types of products through subsidiary companies operating under one umbrella. The South Korean version of state-capitalist, the *chaebol*, includes companies like Samsung and Hyundai. In Malaysia, the state introduced the New Economic Policy in 1969 to help the indigenous groups to own companies. Although, this groups were the highest percentage of population, but in 1980, there were no indigenous-owned companies among the top hundred firms listed on the Bursa Malaysia stock markets.

To finance all these state-owned and state-supported companies, governments would have the options, i.e., to print money or to pull the money directly from state budgets. But, both are not a popular move. The former might lower the value of their currencies, increase inflation and undermine the targeted assets. The later would have to either raise taxes or spend less money on other state projects. Hence, sovereign wealth funds (SWFs) come in. These are state-owned pools of funds can be invested strategically for example to buy shares in strategically valuable companies and institutions, local and abroad. The generated profits can be used for political purposes.

The pools of funds normally come from three main sources: first, foreign currency earned from the export of natural resources, mostly oil and gas; second, extra cash left over from a positive balance of trade; third, the profits produced by state-owned enterprises; fourth, the proceeds from privatization; fifth, a transfer from budget surplus; sixth, a transfer from government-run pension plans; and roll-over investment via direct one-off transfers from a state budget or foreign exchange reserves.

These funds are invested that include a range of financial assets in their portfolio with varying degree of risks (and hence different pay-off) such as foreign currency, shares, government and corporate bonds, commodities, real estate and other assets. They buy shares in domestic and foreign companies, including mutual and hedge funds, and leveraged-buyout firms. What make them different (from other shareholders) (and also it poses a challenge to free market), is that those who manage their investment (as nominee companies) do not answer to shareholders.

Table 3. Size of Sovereign Wealth Funds as the End of 2012

Country	Sovereign Wealth Fund Name	Assets $Billion	Inception	Origin	Linaburg-Maduell Transparency Index
Norway	Government Pension Fund- Global	$803.9	1990	Oil	10
Saudi Arabia	SAMA Foreign Holdings	$675.9	n/a	Oil	4
UAE- Abu Dhabi	Abdu Dhabi Investment Authority	$627	1976	Oil	5
China	China Investment Corporation	$575.2	2007	Non-Comodity	7
	SAFE Investment Company	$567.9**	1997	Non-Commodity	4
Kuwait	Kuwait Investment Authority	$386	1953	Oil	6
China-Hong Kong	Hong Kong Monetary Authority Investment Portfolio	$326.7	1993	Non-Commodity	8
Singapore	Government of Singapore Investment Corporation	$285	1981	Non-Commodity	6
	Temasek Holdings	$173.3	1974	Non-Commodity	10
China	National Social Security Fund	$160.6	2000	Non-Commodity	5
Qatar	Qatar Investment Authority	$115	2005	Oil	5
Australia	Australian Future Fund	$88.7	2006	Non-Commodity	10
Russia	Reserve Fund	$86.4	2008	Oil	5
Kazakhstan	Samruk-Kazyna JSC	$77.5	2008	Non-Commodity	n/a
Algeria	Revenue Regulation	$77.2	2000	Oil & Gas	1
UAE- Dubai	Investment Corporation of Dubai	$70	2006	Oil	4
Kazakhstan	Kazakhstan National Fund	$ 68.9	2000	Oil	8
UAE-Abu Dhabi	International Petroleum Investment Company	$65.3	1984	Oil	9
Libya	Libyan Investment Authority	$65	2006	Oil	1

Table 3. (Continued)

South Korea	Korea Investment Corporation	$56.6	2005	Non-Commodity	9
UAE-Abu Dhabi	Mubadala Development Company	$55.5	2002	Oil	10
Iran	National Development Fund of Iran	$54	2011	Oil & Gas	5
US – Alaska	Alaska Permanent Fund	$46.8	1976	Oil	10
Brunei	Brunei Investment Agency	$40	1983	Oil	1
Malaysia	Khazanah Nasional	$39.1	1993	Non-Commodity	5
Indonesia	Government Investment Unit	$0.6	2006	Non-Commodity	n/a
	Total Oil & Gas Related Total Other	$3,528.6 $2,491.5			
	Total	$6,020.0			

Source: Sovereign Wealth Funds Institute (http://www.swfinstitute.org/fund-rankings/).

There are several reasons why government create and embark on sovereign wealth funds. First, in countries that export large amount of commodities, like oil and gas, metals, minerals, and other commodities, these assets can be transformed into financial assets that can generate wealth indefinitely. They can also help government survive the natural volatility in commodity prices. Some countries had experienced as oil prices reached a new low in 1980s, their budget became deficits.

Second, in countries who earn large amount of export and experience in fiscal surpluses, both can fuel inflation, weaken the local currency, and create consumption bubbles. Sovereign wealth funds can help an economy from the negative impact due to higher export and fiscal surpluses. At the same time, a government can also avoid asking other institutions like the IMF for help.

Sovereign wealth funds tend to be more transparent, more accountable and have clearer governance structures like private institutional investors. The size of some of these funds is literally a state secret. Table 3 provides some insight on of the relative size of the largest sovereign wealth funds as ate the end of 2012. The largest sovereign wealth funds are found in oil exporting countries like Norway (a welfare state), United Arab Emirates[13] and Saudi Arabia. China and Russia also have shown a tremendous interest in expanding their funds. The figures also provide other insights. The insights are that post-Cold War would suggest the end of public wealth era, and private wealth was the next engine of the future. But, the facts show that state capitalism has started to take root.

The trend in state capitalism has developed, it create a new wave. But, the question arises on how much state involvement in an economy is the right way to economic efficiency and hence, generates long-term prosperity? Economists have different views. Theoretically, a system in which producers compete to offer products and services of the best possible quality at the lowest possible price would benefit "consumer sovereignty." To prosper, producer must innovate. As producers invent new ways to push for a lower production cost, the consumer wins. When the state enters the game to limit competition, these gains are reversed.

If the state fails to properly regulate market activity, the free market system may create incentive to players to value "cleverness" (such cheating and corruption) more than prudence. The incentive is to gain short-term benefits rather than long-term investment. For example, in corporate finance, the concept of shareholder value has been widely accepted since 1981,[14] It has created an ultracompetitive environment. They try to maximize quarterly profits at the expense of investment in a sound long-term growth strategy. In another example, the stock market crash that happened in 1987 shows the problems of greedy shareholders who buy and sell shares quickly in search of instant profits. The crisis of "collateral damage" in 2009 and Eurozone in 2011 shows the reckless borrowing and lending, ill-conceived risk taking, poor risk management, and many other human failings (such as unethical behaviour) play crucial roles to those crises. More important in all these mistakes is lack government oversight of all this activity.

The impacts of those crises are also many. The most affected one is on individual unemployment, and indebtedness. The persistent crisis has led to continuing weakening of wages: real wages have declined.[15] Individual with those of limited education may fare even worse and have seen marked

[13] Dubai wants to be known as capital of Global Islamic economy as announced recently, see http://english.alarabiya.net/en/business/economy/2013/10/05/Dubai-wants-to-be-center-for-Islamic-business.html.

[14] The assumption under this concept is that company shares are bought and sold in marketplace, shareholders will collectively allocate a company's resources more efficiently than its management can. In other words, CEO can only be sure that there are managing the company well if more and more investors are pushing its share price ever higher.

[15] Refer to International Labour Organization, Global Wage Report 2010/11.

decrease in their standard of livings.[16] These disturbing trends in income and wealth inequality are outdone by even more disturbing evidence about inequalities in health. As medical has improved, life expectancy has increased, but for the poor countries there has been no progress.[17] Inequality in education also happens. It is due to the cutbacks in government budgets on education and the increase in tuition and fees in colleges and universities. The economic crime also increases due to corruption and criminal that undermined the system such illegal money. All these create unhappiness among the individuals and social impacts such as malnutrition, drug abuse and deterioration in family life.

4. BEYOND THE SYSTEMS: ARE THEY SIMILAR?

In sections two and three, we have discussed on how to make free market work best, free market which is basically a capitalist or state capitalist. There is no evidence that state which regulates economy is in better position than market forces. Both have similarity in the terms of impacts and prescription (which is beyond the systems). We will discuss their similarity in term of the promise that they want to deliver, i.e., social protection, macroeconomic stability and the government policies on interest rate and governance.

a. Social Protection

The market fails to provide adequate safety net, for example, for unemployment and disability. So, the government walked in. But individuals receiving those benefits typically pay for them, either directly (through taxes) or indirectly, through contributions they or their employer maade on their behalf to these protection funds. Beside from an individual's right to draw benefits from social safety net they get involved, social protection can make for a more productive society. Individuals can also take more high-return, high-risk investments if know there is a safety net that will protect them if things do not work out. It is one the reasons that some countries with better social protection have been growing much rapidly.[18]

[16] Studies show that the poor is associated with lower education level.
[17] Refer to http://www.givewell.org/international/technical/additional/Standard-of-Living.
[18] By having an opportunity to invest part of their social protection funds in high-risk investment, individual can invest for example in stock market.

Those who have contributed to these funds are able to get the protection. Many of the individuals at the bottom or low income group who contribute less or not at all are dependent on government benefits. Government has failed in one way or the other. It has failed to provide them with a good safety net system and skills that would make them productive, so they could earn an adequate living. It has failed to stop banks from taking advantage of this "un-bankable" group through greedy lending. It has also failed to stop for profit colleges and universities from taking advantages of their aspirations to move up in their life through education.[19]

b. Macroeconomic Stability and Debt Market

As GDP decreases and unemployment increases, tax revenue fall, and expenditures on social programs increase. The deficit increases. Normally, countries can lower their exchange rate and interest rates (based on classical view) to make their economy competitive, the resulting increase in exports will help boost the economy. Some countries cannot do much to offer these traditional adjustment mechanisms.

The diagnosis of this economy focuses on fiscal parsimony. It was implemented during the Eurozone crisis in 2010. The deficits created an impact on the stability of banking system. It shows the fragility of their economy due to higher exposure on debt. It creates another vicious cycle. In turn, macroeconomic downturn may increase loan losses. Loan losses, then, will destabilize banking system and reduces bank value. The example of sudden macroeconomic downturn includes a sharp fall in oil price, exchange rate shock that influence export income, income shock and change in asset price. A sudden fall in asset price (collateralized by borrowed financial resources) could decrease the collateral value of debt. It starts debt deflation while nominal value of debt remains the same. In addition, asset price fall also cuts borrower's wealth. These two conditions will exacerbate loan losses. It forces bank to default and liquidate assets since the asset price is low.

This shows that there are economic policies that could bring back the economy. What are the prospects that these policies will be adopted? These may create further division between Khaldunian and Keynesian.[20]

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[19] Free education is an option.
[20] Read further in Abdul Ghafar Ismail and Abu Bakar Jaafar (2014).

In other cases, many developing nations are in debt and poverty partly due to the policies of international institutions such as the International Monetary Fund (IMF) and the World Bank. Their programs have been heavily criticized for many years for resulting in poverty. In addition, for developing or third world countries, there has been an increased dependency on the richer nations. This is despite the IMF and World Bank's claim that they will reduce poverty.

c. Interest Rate Policy

The global crises that have surrounded the financial markets since the beginning of the current century only continue to grow, and in some ways London is at their centre. Libor, the London Interbank Offered Rate, is number that plays a key role in a multitude of contracts (such as derivative instruments and mortgages). By linking interest payments to the Libor rate, one allowed automatic adjustments to occur as interest rates rose and fell. Such automatic adjustments, it was believed, led to more-efficient financial markets. It is also the real number that reflected the interest rates at which banks actually lent to each other.[21] But, it was not always true. During the financial crisis in 2007, banks stopped lending to each other.[22] They all knew that they were in trouble, they knew that they could not ascertain their own financial condition, furthermore the financial condition of any other banks. It shows that if no banks want to lend, what could the Libor possibly mean? It is a fictitious number (not be linked with real economy) – on which most of banks may refer to.

This is the interest rate that they normally refer to – as benchmark – for setting the interest rate policy for a country. The banks may manipulate the number – sometimes to garner more profits, sometimes to convince the market that they are sounder than they really are, so sound that they can borrow from others at very low interest rates. The low-interest rate policy was introduced to help bolster stock prices. Consumers are encouraged to borrow. It has benefited the capital owner (in the stock market and financial institutions),[23] it create further inequality of income between shareholders and consumers.

[21] See Abdul Ghafar Ismail et al. (2013).
[22] Find out in Jose Berrospide (2012).
[23] The benefits (in term of money) given to the shareholders (or CEO) not necessarily go into "job creation" and innovation, or go to the poor (by paying zakat), some of it goes into distorting our politics.

The interest rate which is created by human has failed. We should go beyond the human thinking, i.e., the power of Allah (not the invisible hand as proposed by Adam Smith).

d. Governance and Market Institutions

The changes in inequality are related to international rules of the game that are beyond the control of individual countries. It is international rules that govern globalization such trade and financial liberalizations. When those rules allow rich countries to subsidize their rich farmers, global agricultural prices are depressed and many of the poorest in the poor countries, those working in agriculture, suffer. When countries in the advanced countries fail to regulate their banks soundly and to manage their macro economies well, the developing countries and emerging markets often suffer from the collateral damage. And it is typically the poorest in these countries who suffer the most.

The role of government is setting the basic rules of the game, through laws such as encourage or discourage unionization, corporate governance laws that determine the discretion of management, and competition laws that should limit the extent of monopoly rents. However, every law has distributive consequences, with some groups benefiting, at the expense of others. For example, bankruptcy law only has adverse effect up to the liabilities of the company owner not the owner as individual. We have also discussed in section 4(b) that how the rule has set in ways that weakened the income of borrower and enhanced that of capital owner.

In addition, the current systems have created a vampire club of institutions - such as the IMF (International Monetary Fund), World Bank, and NGO’s (Non-Governmental Organizations) - that employ tactics such as loans and structural deficit re-planning to siphon off the world’s resources to the so-called developed nations, leaving behind a gross inequality in distribution of wealth. The world order has resulted in a bleak scenario in which most of the world chokes from the exploitation of a few elitist nations that continue, under the protection of laws and systems that are designed to serve their interests, to squander the wealth of the world and systematically tighten their control of societies around the globe.

5. ISLAMIC ECONOMICS SYSTEM: HOW CAN IT SHAPE THE FREE MARKET?

Islam has its own economic system. How does it support the free market? It is very interesting questions. We would suggest the free market of Prophet (saw) and free market in holding wealth, and the government policy on no interest and creating a welfare system.

a. Free Market of Prophet (Saw)

Markets are supposed to be stable, but the economic crisis (as has been discussed in section 2, 3 and 4) showed that they could be very unstable, with devastating consequences. A closer look at the system showed that this was not an accident; the economic agent had incentives to behave this way.

The feature of the market is also supposed to be its efficiency. But the market is obviously not efficient. The most basic law of economics – necessary if the economy is to be efficient – is that demand equals supply. But, we have a world in which there are huge unmet needs – investment is concentrated in developed countries (due to higher rating), underutilized resources (workers and machines are idle or are not producing to their potential, and unemployment – the inability of the market to generate jobs for so many citizens – is the worst failure of the market, the greatest source of inefficiency.

Prophet (saw) has introduced a free market system in good markets.[24] One day, there was an increase in price, then, they asked Prophet (saw) to fix the price, but Allah determine the price.[25] Price is determined in the market. However, anything that may distort the price or quantity to be demanded or supplied are regulated by the following mechanism: (i) no *ihtikar* – price is not manipulated by buyer;[26] (ii) no hoarding – to avoid the idle resources;[27] (iii) correct measurement to create justice; (iv) provide perfect information (such as

[24] Further discussion on free market in financial sectors can be seen in section 5(c) and also in Abdul Ghafar et. al (2013) and in labour market, see Bayu Taufik Possumah et. al. (2013).

[25] When the prices became high in the Prophet's time and people asked him to fix prices for them, he replied, Allah is the One Who fixes prices, Who withholds, Who gives lavishly, and Who provides, and I hope that when I meet Him none of you will have a claim against me for any injustice with regard to blood or property. (Reported by Ahmad, Abu Daud, al-Tirmidhi, Ibn Majah).

[26] See, Orhan Oguz and Ahmad Tabakoglu (1991).

[27] “If anyone withholds goods until the price rises, he is a sinner.” (Reported by Muslim).

the quality of goods and services) – to avoid unfair treatment in a contract; and (v) no illegal money – to avoid fictitious activities. By having all these elements, the free market can work in the presence of ethical incentives.

As proven during the ruling of Khalifah Umar Abdul Aziz, by having the ethical incentives and economic freedom, it had encouraged business and trade activities.[28] It led to the growth of trade and consequently, an increase in the total revenue of Bay tul mal (zakat on business). Naturally, the allocation of zakat into society led to a rise in the quality of life of lower income group.

b. Wealth

The implementation of Islam would eliminate the stranglehold by which the elites control the policies of the state and the world. Unlike the free markets, Islam will not impose any limits on the amount of wealth that an individual can acquire but there is also the responsibility of the owner to allocate the compulsory and voluntary sadaqah (will be discussed in section 5(d)), thus creating and maintaining an incentive to work. Because the Islamic economic system reflects the wisdom of the Creator which is bundled under the four principles: (i) all the wealth belongs to Allah (swt): "*And give them of the wealth of Allah which He has given you*." [An-Nur: 33]; (ii) the community is the trustee of the wealth: "Believe in Allah and His Messenger, and spend whereof He has made you heirs." [Al-Hadid: 7]; (iii) hoarding of wealth is prohibited: "*And those who hoard up gold and silver and spend not in the way of Allah; announce to them a painful chastisement*." [At-Tauba: 34]; and (iv) circulation of wealth is a duty: "*Whatsoever Allah may restore unto His Messenger - is due unto Allah and unto His Messenger - the orphans and the needy ...so that it may not be confined to the rich amongst you*." [Al-Hashr: 7]. Then, the implementation of Islamic economics system will provide a society conducive to life that will address the needs of humanity based on the correct understanding of life. And also the reminder from Rasulullah (saw), who said, "The son of Adam, if he had two valleys of gold, would desire a third and would not be satisfied till he bites the dust."

While generating massive abundance and wealth of resources by eliminating all the restrictions and oppressive systems that prevent production, Islam will safeguard against abuses of exploitation in acquiring wealth by limiting the way in which wealth is acquired. For instance, Islam denies the

[28] See As Sallabi (2010).

"free" market of Capitalism which has led to the situation of "survival of the fittest." Such an unrestricted environment has led directly to the current situation where multinational companies have hunted the resources of the world like parasites unrestricted in their "freedom."

In Islam, natural and vital resources would be categorized as public property and a right of every citizen of the state - in accordance with the Rasulullah (saw) who stated that "*The humans have a right to three things - water, green pastures, and fire-based fuels (An-Naar)*."[29] In Islam, public revenue from oil and natural resources would be used to secure the needs of all people and not to line the pockets of "elite" rulers. The ruler would provide public and vital resources without charge to cover the needs of every individual and family, and the monopolies that multinational corporations maintain to dictate the lives of the people would dissipate.

The shari'ah also defines certain rules that regulate company structure, effectively preventing abuse and corruption. For instance, Islam forbids monopolies by outlawing the hoarding of wealth, and eliminating copyright or patency laws that would open the avenue for potential monopolies to develop. Also, Islamic economics system also protects the ownership of businesses and companies by restricting ownership of companies only to those who contribute both capital and effort to the company or business, thus effectively putting the seal on such concepts as "corporate takeover" from ever becoming a reality.

In the free market systems of today, the stock market offers no such protection and allows for any outsider to secure a share in any business or corporation and impose his policies on the company agenda, even if that individual puts no effort or work into the business. Today, food manufacturers have cultivated the art of burning surplus food and dumping surplus milk into the ocean to artificially inflate prices by creating "scarcity," an art that would cease to exist with the implementation of Islam.

More importantly, ownership according to the Quranic verses, everything in this universe belongs to God, the Almighty. "*Whatever is in the heavens and whatever is on the earth belongs to Allah*" [Al-Baqarah, 2:284]. He is the real owner of everything. "*And Allah's is the kingdom of the heavens and the earth, and Allah has power over everything*." [Al- Imran, 3:189]. Sadr (1994, 98-114) illustrated that individual ownership, state ownership and public ownership are three parallel forms of possession in Islamic law. Real ownership, however, belongs to Allah. Man holds property in trust and he is

[29] Refer to hadith no 2472 Ibn Majah.

accountable to Him, in accordance with the rules which have been clearly laid down in the Shariah Islami'iah [Islamic Teaching].

c. An Economy with No Interest

As explained in section 5(a), the goods and labour markets are full of inefficiency. The same also goes to financial markets. The inefficiency might be due to law origin. Given the different rights and protections, the law may give the right to contracting parties to deal in unfair transaction. The unfairness in financial markets might be due to unequal sharing of risk as a result of imposing interest rate. In the absence of interest rate, can the economy work without interest? The neo-classical and Keynesian might say no. But, what has been discussed recently on Libor as benchmark, it was extensively attacked by policy makers, academician and bankers. It is not a good indicator in assessing the creditworthiness of borrowers. But, in Islamic economic system, the financial market can work without interest. It can be done by having financial transaction which works based on profit sharing, providing benevolent loans, financing of goods and services on mark-up basis or leasing. Hence, the introduction of profit loss sharing and mark-up and leasing financing might produce fairness and efficiency in financial transactions.

d. Philanthropy

Economists have long recognized that free market fails to produce just and fair economic system.[30] Then, the debate goes on the social programs should be done by government to address the state of welfare. Or the state of welfare should be taken care of by voluntary sector (via philanthropy).

Concept of philanthropy generally which means giving voluntarily. The word voluntary is actually not proper if we look from the perspective of Islam, both in terms of its function or in terms of the history of literature. The philosophical basis of Islamic philanthropy is the "duty" of worship as a

[30] Read further in Muhamad Hasbi et. al (2014).

creature of God, in this case the property is issued or recognized by the general meaning of Sadaqah. From that base it will be found some instruments of philanthropy, there are mandatory, others voluntary. Both are in the category of Islamic philanthropy, such as *Zakāh, Waqf, Nadhr and so forth*.

The Islamic philanthropic activities are not only influential to worship, as a means to get closer to Allah but also socially, in her other influential will strengthen the worship of Allah, the other side it has influenced economic and social change in a positive direction. Sociologically speaking, the first and foremost objective of Islamic charities is to promote the welfare of the poor by eradicating poverty within communities. As a form of collective action, Islamic charities represent Muslim efforts to translate the Islamic creed into reality by reformulating the Islamic faith, so as to be able to impact on the actual needs of society, especially when faced with hardship, social disparities and economic crises. Islamic doctrine has provided plentiful reminders of the fact that creating joy (*al-falāḥ*) in the world and hereafter is a Muslim obligation.

The function of philanthropy has become a part of economic welfare. It can be seen from the role function and the reception and distribution of *Bait al Māl*, where it has functions like the National Budget nowadays. But, unrealistic to expect that everything necessary for development would be specified in the al-Qur'an or the al-Hadith without interpreting. One of the most important and well-known principles of Islamic jurisprudence is that whatever is not specifically prohibited is allowed. Since very few things have been specifically prohibited, there is a great potential for the evolution of institutions needed for promoting development. This did take place in Muslim societies, as Kuran has himself acknowledged by stating that: "The distinguishing economic features of classical Islamic civilization evolved over the next three centuries or so, roughly through the 9th century."[31]

CONCLUSION

Our aim in this chapter is to find out the answer(s) on how Islamic economics system shape the future global economy could. We find that: first,

[31] Kuran, T, Why the Middle East is Economically Underdeveloped: Historical Mechanisms of Institutional Stagnation, Working Paper. Department of Economics University of Southern California, 2004, p. 5.

Islam has its own economic system. Second, it supports the free market. A free market that has two main characteristics: follow the model introduced by Prophet (saw) and free market in holding wealth. Third, the interest rate policy is created by human thinking, which has failed. We should go beyond the human thinking, i.e., the power of Allah (not the invisible hand as proposed by Adam Smith). Fourth, as a means to get closer to Allah, philanthropy could also influence economic and social change in a positive direction that could create a better welfare system.

APPENDIX A: OBJECTIVE OF SHARIAH

The main objectives of the Shari'ah are to ensure that human life is based on *ma'rufat* (good) and to cleanse it of *munkarat* (evils). The term *ma'rufat* denotes all the qualities that have always been accepted as 'good' by the human conscience. Conversely, the world *munkarat* denotes all those qualities that have always been condemned by human nature as 'evil.' In short, the *ma'rufat* are in harmony with human nature and the *munkarat* are against nature. The Shari'ah gives precise definitions of *ma'rufat* and *munkarat*, clearly indicating the standards of goodness for which individuals and society should aspire.

It does not, however, limit itself to an inventory of good and evil deeds; rather, it lays down an entire scheme of life whose aim is to make sure that good flourishes and evils do not destroy or harm human life.

To achieve this, the Shari'ah has embraced in its scheme everything that encourages the growth of good and has recommended ways to remove obstacles that might prevent this growth. This process gives rise to a subsidiary series of *ma'rufat* consisting of ways of initiating and nurturing the good, and yet another set of *ma'rufat* consisting of prohibitions in relation to those things which act as impediments to good. Similarly, there is a subsidiary list of *munkarat* which might initiate or allow the growth of evil.

The Shari'ah shapes Islamic society in a way conducive to the unfettered growth of good, righteousness and truth in every sphere of human activity. At the same time it removes all the impediments along the path of goodness. And it attempts to eradicate corruption from its social scheme by prohibiting evil, by removing the causes of its appearance and growth, by closing the inlets through which it creeps into a society and by adopting deterrent measures to check its occurrence.

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