Financial Thought in Islam Compared to Capitalist and Socialist Financial Thought (Part 1)

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The financial and economic system reflects the philosophy of the state, which is the ideology in which the state believes. The world has known two main ideologies, capitalism and socialism. Some countries have adopted socialist thought, while others have adopted capitalist thought (ideas). As a result, each country developed its own financial, economic, political, and social system derived from one of these two ideologies. As is well known, the goal of these ideologies is to find solutions to human life's problems and to address them, including economic and financial issues, in order to achieve happiness and prosperity for societies each in its own way.

The most prominent feature of the capitalist solution is its reliance on private ownership, individual freedom, and the free market system. Capitalism has gone through several stages, and faced major challenges, such as the 1929 crisis known as the Great Depression, which undermined the foundations of the system at the time, particularly its conventional theory based on non-intervention by the state. This theory failed that test, resulting in a shift from conventional financial thinking to a model of state intervention.

As for the socialist system, it is characterized by reliance on social ownership of the means of production, significant state intervention, and comprehensive central planning. This system ultimately failed after seventy years of implementation, marked by the collapse of the socialist bloc and the disintegration of the Soviet Union between 1989 and 1991.

The Evolution of Financial Thought

The financial system of a state reflects its political philosophy and the surrounding economic and social ideologies it upholds. The state's philosophy is based on a specific viewpoint toward human life, through which it defines the rules of conduct and the social, legal, and economic framework for society.

The financial system is considered one of the tools through which the state achieves its political, economic, or social objectives. Therefore, the financial system, or public finance, varies from one state to another, and even within the same state from one period to another, depending on its economic conditions. Financial thought is closely linked to economic thought, as it is considered a part of it, which means they share the same stages of development. These stages correspond to the phases of the state's evolution and reflect its political, economic, and social philosophy. The main stages are as follows:

1- Conventional Financial Thought, or the Theory of the Neutral or Night-Watchman State (German Nachtwächterstaat)

2- Modern Financial Thought.

Section One

Conventional Financial Thought – The Theory of the Neutral or Night-Watchman State (German: Nachtwächterstaat))

We must first discuss the conventional economic theory before addressing financial thought, as the latter is a reflection of the former.

The conventional theory is based on Laissez-faire: absolute freedom of ownership, freedom of production, and freedom of consumption, with the price mechanism functioning to achieve equilibrium between supply and demand ([1]).

Individuals enjoy the freedom to own both consumer goods and means of production, and to use this ownership as they wish. Capital owners are free to invest their money in any way they choose, to produce goods and services, and to determine the conditions under which they purchase the machinery or materials they need. Freedom of production is matched by freedom of consumption. No individual is prevented from spending their income as they please, or from choosing the types of goods on which to spend it. Individuals compete with one another in pursuit of material gain, producers compete to increase, improve, and innovate in production and to capture markets, while consumers compete to acquire the goods they need ([2]).

Individuals must be free to work according to what their self-interest dictates, to pursue the professions they choose, to move wherever they wish, and to dispose of their property as they please. The state should neither hinder their activities nor assist them. This is the natural law of individual rights what is referred to as Say's Law and Adam Smith's principle of "laissez-faire, laissez-passer" ("let do, let pass"), which holds that the world runs by itself ([3]).

The conventional theory assumes a world of full employment and rests on two fundamental pillars:

First pillar: Supply creates its own demand, meaning that every supply is met with an equal amount of demand. Every good offered in the market generates a corresponding demand, and every demand that appears in the market results in the necessary supply to meet it.

Supply is continuously equal to demand. This equality between total supply and total demand is based on the idea that income which is not spent on consumer goods, is necessarily spent on capital goods that is, on investment ([4]). In other words, all savings are automatically transformed into investment spending, and therefore cannot cause a shortfall in total demand.

The theory assumes a dynamic world in which money does not play an autonomous role; it is merely a medium of exchange. The general price level remains stable, and there are no widespread risks resulting from changes in the value of money. As a result, there is no tendency toward hoarding, and all savings are converted into investment ([5]).

Second pillar: The conventional theory assumes a state of full employment, where supply tends toward full utilization of resources. Unemployment occurs when the supply of labor exceeds its demand, leading to competition among workers, which causes real wages to decrease. This reduction in wages increases producers' profits, which in turn leads to greater demand for labor as producers compete to hire workers.

Thus, economic activity ultimately absorbs all workers. According to this theory, unemployment is temporary and incidental, and it quickly disappears as a result of wage reductions ([6]). At the level of full employment, equilibrium in the national economy is achieved automatically ([7]).

The summary of the classical or conventional economic theory is as follows:

1- The state must not intervene in the economic sector, as long as the private sector alone is sufficient to drive economic progress, because state intervention would harm economic equilibrium.

2- Under the night-watchman state, the role of the state is limited to ensuring external security, maintaining internal order, and undertaking projects and activities that the private sector is unwilling to carry out.

3- Ensuring the flexibility of wages and prices, including the interest rate, as it helps achieve a balance between savings and investment in society.

If savings increase, economic forces will lower the interest rate, which in turn reduces the incentive to save, since according to classical theory interest is considered a component of savings. Likewise, ensuring wage flexibility by avoiding state intervention or conventional regulations helps reduce unemployment, if it exists, by lowering wage levels ([8]).

As for the financial foundations of conventional thought, in the field of public expenditures:

In conventional thought, the scope of public finance was limited to a purely financial purpose, namely, obtaining public revenues to cover public expenditures. These public expenditures had to be financed by distributing their burden fairly among the people ([9]), meaning that each individual’s sacrifice should be equal to that required of others.

The conventional view defined public burdens as the price paid for the security the state provides to individuals. Public spending was expected to be kept to a minimum, based on the belief that the state is a poor manager, unlike the individual, who is seen as more competent in providing services and engaging in production.

Conventional thought prioritized public expenditures over public revenues, in both planning and budgeting, meaning that public spending determined the amount of revenue needed. This principle was easier to apply due to the state’s broad authority to collect revenues and its limited spending needs, as its role was restricted to internal and external security ([10]) and a few projects that individuals were either unable or unwilling to undertake.

As for the principle of budgetary balance:

In conventional financial thought, the principle of budget balance means aligning the state’s expenditures with its regular revenues. Balance is achieved by ensuring that expenditures consistently and periodically match tax revenues. This principle is seen as a goal that must be pursued under all circumstances. It serves as a tool for sound financial management, acts as a constraint on the expansion of state activity and the imposition of additional burdens on the public, and ensures continued balance and confidence in the state’s finances. It also helps maintain economic and monetary stability and supports increased production ([11]).

As for new monetary issuance, printing money, conventional financial thought opposes resorting to it, as it leads to inflation. This is because when it is used to finance consumption expenditures, it injects additional money into the market without a corresponding increase in the supply of goods and services resulting in inflationary price rises. ([12]).

For this reason, conventional economists opposed budget deficits and their financing through borrowing or new money issuance. They also opposed, as mentioned earlier, budget surpluses where revenues exceed expenditures because this means diverting money from its natural course, withholding it, and rendering it inactive. It would be better for such funds to remain in the hands of individuals who could invest them in ways that increase production and societal welfare. Therefore, the state must uphold the principle of budget balance and strive to achieve it at any cost.

As for taxes in conventional thought:

Conventional economists emphasized that taxes should not negatively affect savings; rather, they should help increase them. Therefore, taxes should have a low rate. For this reason, conventional thought preferred consumption taxes, as they lead to an increase in savings ([13]).

The worst types of taxes, according to this view, are those levied on income or capital, as taxing capital leads to its gradual depletion. In this school of thought, taxation is merely a financial tool for distributing the financial burden among individuals, without serving any economic or social objective.

For this reason, the theory prefers indirect taxes i.e., consumption taxes over direct taxes, such as taxes on savings ([14]). The purpose of taxation should be solely to generate revenue to finance expenditures, and only to the most limited extent. Taxation should not interfere with the automatic functioning of the market or alter the financial positions of taxpayers as determined by market forces. This is known as the principle of tax neutrality ([15]), which is tied to the role of the night-watchman state. Conventional thought assigns the state specific functions, beyond which it must not go, otherwise, it would be considered a violation of its neutrality, an unwarranted intervention, and a harm to the public interest.

In summary, regarding the conventional theory:

The conventional financial theory is a reflection of the conventional economic theory, a theory that denied any role for the state in the economic life of society. As a result, the public budget was not assigned any economic or social dimensions, and its objectives were limited solely to the financial aspect.

For this reason, it gave priority to public expenditures over public revenues, emphasized reducing the public budget and maintaining its balance, preferred taxes on consumption over taxes on savings, and upheld the principle of tax neutrality.

Conventional capitalism faced major challenges, as the capitalist world experienced numerous economic crises during the 18th, 19th, and 20th centuries. England, for example, went through crises in the years 1788, 1793, 1810, 1819, and 1825. Similar crises also occurred in the United States, Germany, France, and other European countries, and continued in the years 1857, 1859, 1866, and 1873.

However, the greatest challenge to conventional capitalism was the global financial crisis of 1929, which was one of the consequences of World War I. The capitalist economy was hit by a devastating crisis that shook its foundations and destroyed its means of production, resulting in massive unemployment. After the crisis began in the United States, it swept through all capitalist countries except for Russia and Japan. This was because the socialists in the Soviet Union were steering their economy toward stability and rapid growth by implementing the first Five-Year Plan for the years 1928–1932 ([16]).

This crisis brought about a widespread decline in prices, a downturn in business activity, massive unemployment, bankruptcies, and a devaluation of currencies. It had profound repercussions on the organization of production and trade.

The crisis was so severe and far-reaching that it was not merely a temporary phase caused by overproduction or one of the cyclical shocks that disrupt economic activity every seven to ten years. Instead, it was a systemic crisis—one that struck at the very foundations and principles of the conventional capitalist system itself ([17]).

For this reason, the ideas began to shift toward the necessity of state intervention to prevent the collapse of the capitalist system itself. These ideas left a lasting impact on the direction of fiscal and economic policy, leading to increased government intervention. As a result, the economic and social role of public finance became firmly established.

As a result of this global crisis, voices grew louder demanding that the state intervene to address the catastrophic outcomes and to save the capitalist system from complete collapse. One of the key reasons that compelled the state to participate in the production process was the tendency of the economy toward instability when left unchecked. Free competition could not function automatically without regulation ([18]).

Moreover, the laws of the conventional school did not lead to a fair distribution of income and wealth. The capitalist model of growth produced severe social disparities.

The increasing size of public expenditures, and the shift in their nature, also led to the search for additional financial resources. Wars were a major factor behind the rise in expenditures, which was accompanied by an increase in taxes and borrowing. The costs of war, and the need to finance them, revealed the broad potential of progressive taxes on income and inheritance. This paved the way for the use of taxes and loans to achieve social objectives ([19]).

The conventional theory failed to address this crisis and proved incapable of providing solutions to the economic turmoil faced by capitalist systems in the second decade of the last century. As a result, a new theory emerged in the 1930s: Keynesian theory, which emphasized the necessity of state intervention in economic life, the expansion of its role, and the end of its neutrality. This marked the beginning of a new phase the era of modern financial thought or the theory of the interventionist state, which will be discussed in the second section of this chapter.

Section Two

Modern Capitalist Thought – The Theory of the Interventionist State

Modern financial theory views state intervention in the economy as essential, calling for an expanded role for the state and an end to the neutrality that characterized conventional theory up until 1929. This is because economic equilibrium cannot occur automatically.

While modern economists agreed on the need for state intervention, they differed in how far that intervention should go. Some most notably Keynes called for state involvement in specific areas, where the state would act as a guide for other economic activities, using its financial and economic tools.

Others among modern thinkers went further, advocating for financial planning, and a broader state role, including the ownership of the means of production, thus allowing the state to direct the entire national economy in terms of both production and consumption. These were the advocates of socialism ([20]).

Therefore, we will first discuss modern Keynesian theory, and secondly, financial thought in the socialist system.

First Interventionist Theory: The Keynesian Theory:

John Maynard Keynes (1883–1946) asserted that capitalism, upon entering its final stage, had lost its original competitive nature, and could no longer be self-regulating or automatically balanced. Therefore, it had to be consciously controlled and directed ([21]). Keynes effectively dismantled the idea of the “invisible hand” and called for the necessary intervention of the state in economic life to achieve equilibrium.

We must examine the assumptions of Keynesian theory in order to understand the foundations of interventionist financial thought.

Keynes opposed the conventional theory on three fundamental grounds ([22]):

1- The claim that general equilibrium occurs automatically, without the need for government intervention in economic activities.

2- The belief that supply can automatically, or independently, achieve equilibrium at the highest levels of full employment for all factors of production.

3- The assertion that money is a neutral factor in economic operations and therefore has no impact on those operations themselves.

Keynesian economic theory sparked a revolution in the world of capitalist economic thought, and played a pivotal role in addressing the 1929 crisis. It brought an end to the conventional theory, which had failed to resolve the crisis.

The foundations of modern financial thought, or interventionist finance, are as follows:

First Foundation: The Role of the State in Economic Activity

As a result of the divergence between conventional and modern economic theories, financial thought also developed accordingly. Given the failure and inadequacy of the conventional theory, it became both necessary and essential for the state to intervene in economic life. This led to a growing importance of the state budget and its instruments, revenues and expenditures, as the state began to play an active role in all areas of the economy.

Production within each country was no longer left solely to individual initiative. Governments gradually began intervening in economic life not only to regulate working conditions, but also to control prices, interest rates, the distribution of raw materials, and production itself. In many cases, governments did not hesitate to replace private initiative to manage certain essential services and key industries ([23]).

Once it became clear that the market mechanism, and price system, were incapable of achieving full employment of economic resources, and that individual decisions by producers and consumers could not fulfil that goal either, it became necessary for the state to intervene using its fiscal policy to stimulate or restrain effective demand, depending on the economic conditions ([24]).

Through its fiscal policies, both spending and taxation, the government can address imbalances in effective demand and achieve economic equilibrium. If effective demand decreases (as in a recession), the government compensates by increasing public spending and reducing taxes until demand rises to the level of full employment.

Conversely, if effective demand exceeds the level of full employment (as in a case of inflation), the government reduces public spending and increases taxes ([25]).

For this reason, it became unacceptable for the state to remain neutral, as conventional theory had advocated. Thus, interventionist capitalism replaced conventional capitalism.

Second Foundation: Achieving General Economic Equilibrium Instead of Budgetary Balance

Conventional theory focused on balancing the budget from an accounting perspective, that is, ensuring that state revenues matched expenditures. It viewed financial issues in isolation from the broader economic life of society. Budget balance was considered a primary goal of fiscal policy, and as the state was seen as neutral, it was not permitted to deviate from this principle by resorting to borrowing or the issuing of new money ([26]).

However, with the emergence of economic crises and the collapse of this theory in light of new economic conditions which proved that economic equilibrium does not occur automatically. National economic equilibrium replaced budget balance as the state's new objective. Keynes' experience demonstrated that fiscal policy is meant to achieve economic equilibrium, as the economy does not always balance at full employment.

In cases of recession, effective demand falls below equilibrium, and the state must abandon the idea of a balanced budget, and deliberately run a deficit, by increasing expenditures beyond revenues, and financing the gap through public borrowing or issuing new money to reach full employment equilibrium ([27]).

In contrast, during inflation when effective demand exceeds the level of full employment, the state generates a budget surplus by increasing revenues, reducing expenditures, or both, in order to restore balance.

Thus, restoring the economy to full employment is enough to rebalance the budget, due to increased tax revenues, or reduced public spending. Therefore, the budget and its fiscal tools, taxes and expenditures, are no longer just instruments to generate revenue and cover spending, but have become responsible for achieving balance:

Economically, by reaching full employment equilibrium,

Socially, by ensuring stability and "social justice" through raising the living standards of the poor, via redistribution of national income.

Second Interventionist Theory: Financial Thought Under the Socialist System

The development of financial thought varies according to the evolution of a society's economic thinking. Therefore, the financial system differs depending on the prevailing economic and social systems. As is well known, the evolution of financial thought has been a result of the transformation of the state's role from a night-watchman state to an interventionist one.

However, this development did not stop there. It extended further, transforming the state, from merely an interventionist force aimed at maintaining economic and social balance, into a productive and distributive state, that takes on the responsibilities of production and distribution according to an economic plan.

The fundamental differences in the financial system between capitalism and socialism stem from the differences in the countries' economic and political systems, as well as from the distinct nature and roles of the socialist state versus the capitalist state.

The socialist economic system is based on two main pillars ([28]):

1- Social, collective ownership of the means of production

The socialist economic system is based on the social ownership of the means of production, achieved by eliminating private ownership and dismantling the power of the class that possesses these means. This form of ownership serves as the economic foundation for the dominance of the working class, the toiling masses to achieve their goals by establishing a new economic system marked by social relations in which no individual exploits another.

Ownership in the socialist system takes various forms: state ownership (the public sector), cooperative ownership, and private ownership (in a limited sense). As a result of this structure, the primary levers that control the national economy lie in the hands of the state. The socialist state plans and directs the entire process of production, distribution, and consumption of goods, products, and services with the aim of fulfilling public needs.

It carries out its economic function based on the principle of social ownership of the means of production, coordinating the national economy to serve its economic, political, and social goals in order to ensure a happy and secure life for all segments of the population ([29]).

2- Organization of the National Economy and Central Planning.

The national economy in socialist countries is managed on the basis of comprehensive economic plans, which determine the development of production and consumption.

This planning encompasses all aspects of the country's economic and social activity and involves all economic and administrative institutions. Resources and their uses are planned in advance for each economic and administrative unit.

In addition to national economic plans for the entire country, there are also local plans at the provincial level and sub-plans for other sectors and agencies ([30]).

It is a comprehensive planning system that covers all aspects of societal life. Central planning means centralized direction and control over capital accumulation rates and the general principles guiding economic growth trends ([31]).

It is a method for organizing economic activity to achieve specific goals within a defined time period, by making full use of the community's resources.

The goal of socialist states in adopting central planning is to bring about necessary, long-term transformations in the economic and social structure, generating an order that ensures justice in income distribution, equal opportunities for all, and limiting capital, both as an economic power, and as a tool of influence over the country's public policies.

The social ownership of the means of production, central planning, and the state's role in production and distribution according to national plans have made public finance in socialist states closely intertwined with the national economy.

It plays a significant role in production and distribution relations as well as in economic processes.

The role of the state is no longer limited to achieving economic and social balance as in the interventionist state but also includes direct involvement in production and distribution.

As a result, the foundations of the financial system in a socialist state differ fundamentally.

To be continued…

Footnotes:

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