

Regulation or Deregulation of an Economic Entity: A Normative Analysis

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Abstract: *Government intervention in the market economy is a controversial issue due to the philosophical differences in the political ideologies of the decision-makers. There are some areas which are mainly controlled by the government because of its superiority and the structure; these are: ensuring social safety and security, providing basic needs and compensating negative externalities, etc. There are two broad swings of the pendulum regarding the practice of government intervention. Some believe that market failure requires government interference while others disagree. This is an ongoing debate whether government is eligible to intervene in the economy and if so then to what extent. The existing research findings do not come up with a decisive solution in this regard. This study is a critical appreciation based on the arguments of different thinkers in favour and against government intervention. It has been argued that government intervention is a must for any economic entity because only government is answerable to the people and if we allow government to interfere in the crisis situation then it is better to allow government to handle the economy forever.*

Introduction

State versus market constitutes the evolutionary paradigm of economic doctrine. Classical model is at one extreme, neo-classical synthesis is at the intermediate stage and market economy with its derivatives such as executive agency (as in U.K.), privatization of public utilities such as telephone, railway etc. are at the other extreme. The heyday of classical economics culminated in the onslaught of depression of 1930s. The success of Keynesian economics in weathering the recession is a testament of active state intervention which advocated that, "Government intervention through expansionary fiscal policy is needed" (Sullivan & Steven, 2003, p.395). During that time US President Roosevelt enacted the Glass-Steagall Act, 1933. But Clinton Administration repealed that act in 1999 and from then on the financial crisis began and turned into economic crisis (Rudd, 2009). Governments across the globe have been aggressively battling the current financial crisis using fiscal stimulus, monetary easing, as well as structural intervention. There is now a controversy as to the proper role of government in economic activity (Zerbe, Jr. and McCurdy, 2000). Some economists argue that government should play the role of a catalytic agent, as in the chemical process, accelerating the pace of development through ensuring congenial environment for development while others believe in *Laissez-faire*. So there is a dichotomy regarding the operating system of an economy between non-interventionist and interventionist (Lipsy, 1989, pp.747-75).

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On the basis of a practical situation let us consider an example, if your internet service provider is delaying without any definite reason then the government may be the sole competent authority to provide a way out the situation. But government has limitations, even sometimes not competent enough to resolve the problem (Weil, 2005, pp.348-60). So there are two things to consider, firstly, whether government will intervene and secondly, if we allow intervention then what is the optimum level? Is it only in the crisis situation, or only in regard to social welfare or to regulate the business, the discussion is huge in terms of the issues.

The role of the state is a historical event. The reestablishment of American capitalism after the Great Depression in 1930s, the engineering of Marshal Plan after World War II, Asian contagion in 1997-99 and the recent bailout package for USA capital market in 2007-08 are the lucid examples of government interventions (Allen and Gale, 2007, pp.1-6). Therefore the role of the state is a non-ending process since the history of the civilization. The recent financial crisis explores the role of the state once again as a fundamental issue (Rudd, 2009).

In a mixed economy the appropriate role of the government is not resolved rather it encourages disputes between the normative views in favour of and against the government role (Nelson, 1987). This paper makes an attempt to explore the ongoing debate on government intervention. The recent crisis in the US sub-prime loan for housing sector fuels the dispute between regulation and deregulation of the economy. The debate has been raging among economists for much of this century: should governments intervene during times of economic crisis? To a greater extent the analysis refers to US economy, the world's economic giant but this study is a general observation. The dominance of US financial system in the world economy is the major reason for the above justification.

This is a literature review and for that reason no separate literature review is given here. This article first briefly discussed whether the government should support the troubled corporation or not. Then it examines the scholarly arguments and comments of different researchers with respect to the dichotomy of two different thoughts in favour of and against the government practice. Secondary evidences have been used to serve the purpose. We paid attention particularly on some technical terminologies, arguments of different thinking, and the historical views of economic intellectuals. This work is expected to provide valuable information for the researchers to conduct further research and help the policy makers to set the strategies in terms of improving the socio-economic development and prosperity of the globe.

One of the limitations of the study is that it doesn't observe any trends of any particular economic entity on the basis of empirical evidences. More importantly, this analysis is not country specific so it may create ambiguity if someone plans to relate with any particular economic unit. The excuse of those limitations is that this study is not a quantitative analysis rather a general discussion of the role of the government.

The paper proceeds as follows: in Section-1 there is an introductory discussion while Section-2 develops the methodology of the study. A separate section (Section-3) is added here to provide a comprehensive idea about the global financial crisis because it has been the landmark of the 'regulation or deregulation debate'. Section-3 articulates the cause of the recent global financial crisis and global responses to fight against the crisis and role of the government as well for that particular period of time. Section-4 critically examines the potential areas where the government can intervene. The succeeding section (Section-5) describes the writings as well the findings of scholarly comments in favour of and against the government intervention. Section-5 has the paramount importance because it is the core section of this study. The next section contains the concluding remarks of this paper.

Methodology

This paper is completely based on theoretical arguments of different books, journals, websites and intellectual writings (published & unpublished) of different authors. Here we tried to analyze the findings and comments of scholars. In this paper no data are used and no testing of hypothesis is considered. So this is just a theoretical elaboration of the arguments in favour of and in against the government intervention. The recent global financial crisis is the starting point of our discussion. The whole discussion is based on the secondary evidences.

Cause of the Recent Economic Crisis

The causes of the recent global financial crisis are already reasonably clear. It could be argued that the crisis is a result of deregulated financial markets or the raw functioning of capitalism, based on the idea of 'free markets'. It originated in a series of interconnected developments within the American financial sector.

George Soros (2008) said,

"The salient feature of the current financial crisis is that it was not caused by some external shock ... the crisis was generated by the system itself".

Australian former Prime Minister Kevin Rudd (2009) added that the current crisis is the culmination of a 30-year domination of economic policy by a free-market ideology. The central thrust of this ideology has been that government activity should be constrained, and ultimately replaced, by market forces. A housing market bubble began in the late 1990s and accelerated in the early-mid 2000s. Banks and mortgage brokers pushed mortgage sales because they earned fees in proportion to the volume of mortgages they wrote (James, 2008, p.3).

Demand for high yield products based on mortgages was so great and bank fees so large that banks and brokers began to sell mortgages to those who could not afford them under terms that were bound

to trigger large defaults when the housing price bubble evaporated and/or interest rates rose. The whole process was driven by accelerating leverage (James, 2008, p.3).

In 1998, Brooksley Born, the head of the Commodity Futures Trading Commission argued for the regulation of this market. Without it, she argued, the American economy and the global economy were being placed at risk (Bloomberg, 2008). At the same time, as a consequence of a \$300-million lobbying campaign by financial corporations, Congress also repealed President Roosevelt's Glass-Steagall Act, 1933. Its purpose had been to separate the commercial banks, which had become involved in the speculative frenzy of the '20s, from the activities of the investment banks. The repeal of the Glass-Steagall Act opened all the American major banks to massive involvement in the derivatives market (Rudd, 2009).

Global Responses to Fight the Crisis

The governments all over the world over are intervening in the financial markets like never before. They have provided liquidity in hundreds of billions of dollars, lowered interest rates to revive the economy, pumped capital into financial institutions in trouble, forced mergers of weak institutions with stronger ones, brought an end to Investment Banking, etc. Monetary authorities have changed the cash reserve ratio (CRR), etc. Funds have been found when they have not been available for interventions in social sectors like, health or for employment, infrastructure maintenance, housing, etc. One wonders what will happen to the Fiscal deficits of the major OECD countries since they are offering huge sums to businesses (Kumar, 2009, p.3).

According to the International Herald Tribune, on September 16, 2008 China cut its interest rate for the first time since 2002. Indonesia reduced its overnight repo rate, at which commercial banks can borrow overnight funds from the central bank, by two percentage points to 10.25 percent. The Reserve Bank of Australia injected nearly \$1.5 billion into the banking system, nearly three times as much as the market's estimated requirement. The Reserve Bank of India added almost \$1.32 billion, through a refinance operation.

In October 8, 2008 the British Government announced a bank rescue package of around £500 billion (Jamieson, 2008). The plan comprises three parts. First, £200 billion will be made available to the banks in the Bank of England's Special Liquidity scheme. Second, the Government will increase the banks' market capitalisation, through the Bank Recapitalisation Fund, with an initial £25 billion and another £25 billion to be provided if needed. Third, the Government will temporarily underwrite any eligible lending between British banks up to around £250 billion.

In November 9, 2008 the 2008 Chinese economic stimulus plan is a \$586 billion stimulus package announced by the central government of the People's Republic of China in its biggest move to stop the global financial crisis from hitting the world's fourth largest economy. The stimulus package will be

invested in key areas such as housing, rural infrastructure, transportation, health and education, environment, industry, disaster rebuilding, income-building, tax cuts, and finance. Japan Taro Aso announced \$51 billion stimulus package (International Herald Tribune, 2008).

In the US, the epicentre of the financial crisis, the new Obama administration passed the largest fiscal stimulus package in US history, with a price tag of \$787 billion (Davies, *et al.*, 2012). The package contains both direct spending on infrastructure, healthcare, and other projects with universal benefits. These steps have been complemented by monetary easing, with unprecedented reduction in interest rates -- to almost zero. The government has also been aggressive with structural intervention, most visibly in the banking sector, which is in meltdown mode with 14 banks already failed. Imam (2009) stated that,

“In 2008, the government engineered healthier banks to buy the weaker ones, and has set aside \$700 billion under the Troubled Asset Relief Program (TARP) legislation. Importantly, there is now discussion in the US about setting up a "Big Bad Bank" (BBB) to buy up the hundreds of billions of dollars worth of toxic assets sitting on the balance sheets of banks, and quarantine these assets.”

Governmental Role: Possible Areas and How to Intervene

There is now a controversy as to the proper role of government in economic activity. The first point to consider is whether government should intervene and the next one is at what level? If we allow the government intervention in the crisis situation to save the troubled corporations with the tax-payers' money then it may be ethically wrong. The profit seeking organizations enjoy their earnings in the good time without paying anything to the tax-payers then why the tax-payers would spend their money for the businessmen in bad time. So the rescue strategy is not at all acceptable in one sense.

Many economists argued that the government intervention is required mainly for market failure which is the outcome of negative externalities, provision of public goods, asymmetric or imperfect information as well as market imperfection (Ribaudo, *et al.*, 2008 and Young, 2004, pp. 983-85). In this paper these areas are not scrutinized rather we focus on the wide areas of government intervention and we do not examine the causes of government intervention. It is a summary of general observation about the enduring debate about government interference in the economy.

A few economists argue that government should play role of a facilitator to accelerate the pace of development. Institutionalizations of development process through promulgation of rules, creation of physical and social infrastructure are some of the crucial aspects that need government active patronization.

Joseph Stiglitz (1998) elaborated on proper role of government and identified some important areas where intervention is required to expedite the development process. He argued that few areas where government should intervene:

- a) Promoting technology- the government must patronize innovation and re-orientate the endogenous technology to augment productivity.
- b) Supporting the financial sector- financial sector discipline and healthy norms help development of capital market and ensure capital accumulation for investment in the most efficient way. The safety and soundness of financial institutions ensure long term investment climate.

Government can offer two major types of stimulus package in an economy – fiscal stimulus and monetary stimulus (Imam, 2009).

Fiscal Stimulus

It involves public sector spending above normal levels in order to stimulate the economy. Keynesian economies strongly argued for fiscal policy because it is the only effective way for the market correction (Stiglitz, 2008a). There are typically two ways to provide fiscal stimulus:

Direct spending: The government can increase its budget above normal level and spend the excess on projects -- roads and bridges, mass transit, education, energy supply -- with the goal of creating new jobs and improving the long-term competitiveness of the economy.

Tax cuts: The government can lower the tax rate, or provide special tax incentives, to individuals and businesses. This action increases the amount of money available to the private sector to spend on the economy. However, tax cuts can be less effective than direct government spending to stimulate the economy; individuals and businesses can simply choose not to spend the tax breaks or not to take advantage of tax incentives. It has been found that in the period of household debt and high uncertainty tax cuts are unsuccessful as they were in Japan in 1990s (Stiglitz, 2008a).

Fiscal stimulus, while effective in short-term can be harmful in the longer-term. First, fiscal stimulus creates budget deficits (difference between what the government spends and what it earns), typically finances through borrowing. As the debt load becomes larger, the government has to impose higher and higher taxes to service the debt, eventually threatening the solvency and stability of the economy. Second, fiscal spending creates unintended distortions in the economy; government programs can end up directing capital to sectors that may not be the best use of resources.

Monetary Stimulus

In the recent times monetarism dominates the economy where the economy is mostly determined by the money supply (Machaj, 2007). It involves increasing the availability of money in the economy, typically through the banking system. The objective is to make it easier for retail and business customers to borrow from banks and spend it on the economy, thereby counteracting recessionary pressures. This can be achieved in one of several ways:

Interest rate cuts: By lowering the interest rates banks can charge on loans or offer for deposits, the government makes it less attractive to save money and cheaper for companies and individuals to borrow.

Quantitative easing: The government can inject funds into the banking system by lending to banks directly and/or by buying assets from banks (such as bonds). The goal is to "ease" pressure on bank assets, thereby allowing them to lend more to retail and business customers.

Reserve reductions: Monetary authorities require banks to hold a certain portion of their assets with the central bank. By reducing this requirement, the central bank can free up banks' capital, which in turn is used by them to increase lending.

Monetary stimulus for too long a period is not good, for the very reason that monetary stimulus is useful in a downturn, it can be harmful in an upturn. Easy money tends to create "credit bubbles" or excessive expansion fueled by excessive levels of borrowing. In fact, availability of easy money in developed economies during the last two decades is one of the root causes of the current financial crisis. And given that economic policy is not precise, governments tend to wait too long to turn-off the excess money flow, thereby creating bubbles in the long term.

Whether Government to Intervene or not

In Favor of Intervention

Adam Smith, the pioneer in arguing against the governmental role advocated a free market where individuals will enjoy freedom. Smith in his book *The Wealth of the Nations* argued that,

“As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it.” (Smith, 1776, p. 477)

But if everyone is busy with his own interest there must be a lack of coordination. The crucial argument in favour of government intervention is the requirement of coordination. Government is the sole agency to coordinate the individuals, business firms as well as the private entrepreneurs. Let us begin this part with the global financial crisis in the recent time. The US Financial Market fails because there was less government involvement. House Speaker Nancy Pelosi indicated,

“Budgetary recklessness, on an anything- goes mentality, with no regulation, no supervision, and no discipline in the system.” (The Guardian, 2008)

President Obama also repeatedly blamed ‘deregulation’ for the crisis (Wallison, 2009). Therefore, it has been widely accepted that the crisis required government intervention. There is no doubt that

immediate action has to be taken in order to cope with the crisis of such magnitude. Otherwise, severe consequences for the financial system, as well as for the global economy would be inevitable. Dunlavy (2008) argued that *Laissez-faire* is a myth while America has a long established reputation of government in terms of taking initiatives and enhancing economic growth.

The general path of government intervention and fiscal policy is subject to ongoing debate. So the question is raised that are rescue packages appropriate? Governments worldwide have structured rescue packages to support financial institutions in distress. This raises an important question: should distressed/troubled financial co-operations/institutions be rescued by the government and consequently by tax payers? In one hand, rescue measures seem appropriate given that the bankruptcy costs for the economy would exceed the costs of the rescue. On the other hand, with a government as the lender of last resort, there is little incentive for financial institutions to pursue sophisticated risk management strategies. In contrast, the incentive would be to increase the overall risk profile of the institution in order to obtain a higher expected payoff for shareholders. With a lender of last resort, shareholders are equipped with a put option written by the government, generating an incentive to increase the risk profile of the firm at the cost of the government (Breitenfellner and Wagner, 2009, P.12).

In the words of legendary economist John Maynard Keynes, "Free markets are not always self correcting" (Riley, 2011). We need more severe and efficient regulation, higher capital requirements to underpin financial trades, more transparency and a global institution to independently oversee the stability of the international financial system (The Financial Times, 2008).

The crisis is one fold of analysis. The other areas where government should intervene are safety and security, social justice and equity, creating positive externality and compensate the negative externality. It has been a prerequisite for the government to ensure security for the citizens. Stiglitz (2008b) argued that well designed regulation not only guarantee the market efficiency but also ensure an equitable market outcome.

Given the issue that has developed over the year there is reason to be optimistic about the governmental intervention in term of cash or subsidy. Watkins (2008), who is the co-winner of the 1st John Kenneth Galbraith Prize in 2008 advocated in favor of the governmental intervention. The market mechanism alone cannot perform all economic functions; public policy is needed to guide, correct, and supplement it in certain respects. Government action should only occur where market fail, providing governments would do a better job in those particular circumstances.

Against the Governmental Intervention

In the recent history, the issue of government intervention becomes more popular due to the difference in the political ideologies. The capitalist society does encourage less government

involvement in the economic activities for more capital generation having fewer regulations. The argument against the government attachment in the economy can be articulated by a famous quote stated by Nobel Laureate Economist Freidrich Hayek,

"Government intervention usually makes a bad problem worse. The most efficient economy is one left to its own devices." (Scribd, (n. d.))

In this connection a similar proposition is delivered by W. Rogers (1993, p.93),

"We should never blame the government for not doing something. It is when they do something is when they become dangerous."

One of the important justifications regarding government intervention is market failure which is a loaded and value-laden term (Rozeff, 2006). If market fails the government must intervene which is a common belief. But Rozeff (2006) argued that the government inference is not justified in intruding individual's sovereign decision-making process. He also stated that those who are interested to focus on market failure never identify the market success.

The history of market failures allows us to make a dissection of the Great Depression in 1930s. No one disagree regarding the aftermath of Great Depression and the contribution of the government in depression period but in the recent days economists believe that inconsistent macroeconomic policies is the main reason for crisis or market failure (Allen and Gale, 2007, pp.1-6). So, government is the cause of crisis and market is the solution.

Hausman (2008) stated some problems, like administrative costs, lack of information, rent-seeking, corruption etc. are faced by the government when they are interested to address any issue. Considering all the potential problems associated with the governmental intervention let us make a summary of the list. Firstly, where does the government get its money from? Government spending comes from three sources: taxes, debt, or inflation (or a combination of these). These all boil down to one primary source: taxation. Government's remedy is to increase public spending by raising more in current or future taxes. Taxes simply transfer (current or future) resources from consumers to government, displacing private spending and investment. Taxation comes with costs. Higher taxation encourages tax avoidance, which causes people to change their behavior. They may engage more in non-taxed activities, such as household production. Economists explain that these behavioral changes create a "deadweight loss," i.e. resources that could have been created but aren't—we are all impoverished as a result. Caccomo (2008) argued that any increase in the tax-burden will be accompanied with a series of negative externalities, like, tax evasion, corruption, the expansion of underground economy and black market, the peoples' way of thinking as well as the crowding out effect.

Second, government cannot create wealth. When the government directs resources to government-identified uses, there is no guarantee that these funds are being put to their best possible uses (Eileen & Frederic, 2008, p.3). Government lacks the incentive to identify relevant, socially beneficial

investments. Unlike entrepreneurs, government officials are not guided by profits and they do not suffer losses if they misallocate resources. Only entrepreneurs, who risk their capital, are positioned to identify and exploit opportunities for wealth creation. At best, government spending displaces jobs and misallocates resources, producing a “negative multiplier effect,” zeroing out any positive effects created by new government spending.

Third, we don't know what portion of income the newly government- employed individuals will consume. They may choose to spend now or later. As crisis brings greater uncertainty, many people may choose caution: spending less now is a safety mechanism. The multiplier effect, however, is predicated on consumption estimates that may not work in times of crisis.

Finally, government-generated job counts are taken as evidence of guaranteed economic activity. But for economic benefits to occur, it matters how jobs are created. Jobs created by the private sector result from entrepreneurial innovation and trade. This process leads to real productivity gains and higher standards of living. At the end of the day, the government cannot replicate what only private entrepreneurial activity can do.

De-emphasizing regulation and intervention, the proponents of the free market approach instead subscribe to a concept of economic Darwinism; only the fittest companies making rational economic choices should thrive, while those making bad choices must fail.

A logical, although unintuitive conclusion of this theoretical construct is that recessions are inevitable, and even necessary. When demand rises, a virtuous expansionary cycle sets in; companies increase production, creating new jobs and improving wages, and in the process generating new demand. However, the expansionary forces tend to drive companies to excess -- creating too much capacity, taking on too much debt -- factors that eventually lead to business failures. As the failures pile up, companies shed capacity, cut employment and wages, and drive down demand -- the economy enters a recession. Therefore, recessions are inevitable and necessary; they purge the excesses that accumulate in an economy during the good times. A free market proponent will then argue against intervention to prevent a recession.

Conclusion

Governmental intervention in general and its role in promoting economic development in particular has long been a debated issue. In the light of the above discussion it is detected that there exists a huge area of controversies regarding the governmental intervention in promoting economic development. Market failures are a consequence of non-competitive behaviours, externalities, lack of property rights and production of public goods (Broadway and Bruce, 1984, pp.103-04). Historically, government intervention due to market failure has been proved. In addition, the governmental role in terms of subsidy and cash injections into troubled corporations from public purse in the current

context of global financial crisis and economic uncertainties has been unanimously accepted. Not doing anything may be an option. But how can inaction in the face of an economic crisis be an option? So the rescue is inevitable. For the time being it is essential that all governments continue with their efforts to manage the crisis of the economic entity.

It has been found that in the crisis situation we allow government intervention to rescue the economy. History supports this approach but what's wrong if government does it before it happens. It is better to have prevention rather than medication. Though the market economy is the sole guarantor of ensuring efficiency but when it fails it is the liability of the government to save it from the disaster. The government is accountable for the rescue operation because market failure involves employment, budgetary management, revenue collection and consequently the overall economic development and prosperity. So ultimately government is answerable for the destination of the economy. If we allow government to intervene in crisis period then ethically it is absolutely fine to allow the government to intervene before it happens. The government association with the economy will unlock the option to set a mechanism where check and balance can be ensured.

Though the management of government, particularly in poor countries, is not efficient to a greater extent (Méon and Weill, 2005) but we need to think of it as the solitary institution which has plenty of commitments to the people nationally and internationally. Therefore, in the modern phase of global integration the presence of government role is inevitable. Even to a greater extent non-interventionists are in favour of minimal direct involvement of the government in the economic system (Lipsy, 1989, pp.757-58). Government intercession is required to guarantee social justice and equity, to create an environment where private sector can perform efficiently, to provide basic needs for the citizens as well as it gives room to reduce negative externalities. Thus, we strongly recommend government intervention in the economy where the market will operate in such a way that it can find its own path of long-term development. To conclude, it is high time to focus on the governmental efficiency rather than the role of the government to make sure that the economy is on the right track despite the possible ups and downs in the market mechanism.

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