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## ECONOMICS OF THEFT

### ЕКОНОМИЈА ПЉАЧКЕ

**Summary:** *'Economics of Theft' analyses theft as an economic and social activity. The article challenges conventional attitude to theft as repulsive activity which causes moral indignation. Theft is analysed through two criteria which economists usually use when judging any economic activity; efficiency and equity. In addition to these two criteria a third one is introduced, namely the optimal level of theft. In a vast majority of cases theft redistributes income from better off to worse off; therefore, theft passes the test of equity. Also, at lower levels a thief's utility exceeds the damage which a victim of theft suffers. As levels of theft increase, marginal utility to a thief falls and marginal damage to a victim of theft increases. Optimal level of theft is achieved when marginal utility to a thief equals marginal damage to a victim of theft. Economists do not feel any moral indignation to theft since it passes the test of equity. What concerns economists is the fact that theft is unproductive activity which does not create any new value. Theft, therefore, does not pass the test of efficiency. The article analyses and compares theft with several economic activities which do not create any material, intellectual or spiritual value and which pass neither the efficiency nor the equity test. Those activities might cause moral indignation but are perfectly legal. Economists can justify theft until optimal level is reached, i.e. when the thief's utility is equal to the damage suffered by a victim of theft. Laws, however, punish every theft even when it is socially just. Apparently, there is a friction between the economic theory and the legal system. Something must be wrong either with the economic theory or with the law. Or maybe both of them are wrong. A possible explanation might be found in Montesque's statement that the legal system is a network through which big fish pass and small fish are caught.*

**Keywords:** *Efficiency, Equity, Creation of New Values, Optimal level of Theft, Marginal Utility, Marginal Damage, Thief's Gain, Victim's Loss, Economic Theory, Law*

**JEL Classification:** *A1, D63*

**Резиме:** *Чланак "Економија пљачке" анализира пљачку/крађу као економску и социјалну активност. Рад се супротставља конвенционалном ставу према којем је пљачка дегулантна активност која изазива моралну индигнацију. Пљачка/крађа се анализира кроз призму два критерија која економисти обично користе у ојени било које економске активности; ефикасности и праведности. Уз то је уведен и трећи критериј, оптимални ниво пљачке. У великом броју случајева пљачка прерасподјељује доходак од имућнијих ка мање имућним. Стога, она пролази тест социјалне праведности. Такође, на нижим нивоима добит/корист лопова превазилази штету коју трпи жртва пљачке. Са повећањем нивоа пљачке гранична корисност лопова опада а гранична штета жртве пљачке расте. Оптимални ниво пљачке је достигнут када се гранична корист/добит лопова изједначи са граничном штетом жртве пљачке. Економисти не осјећају никакву моралну индигнацију према пљачки пошто она пролази тест социјалне праведности. Оно што забрињава економисте је чињеница да је пљачка непродуктивна дјелатност која не ствара никакву нову вриједност. Пљачка, према томе, не пролази тест ефикасности. У раду се пљачка анализира и пореди са неколико економских дјелатности које не стварају никакву материјалну, интелектуалну или духовну вриједност и које не пролазе тестове ефикасности и праведности. Ове активности могу изазвати моралну индигнацију али су у перфектном складу са законом. Економисти могу оправдати пљачку док се не достигне њен оптимални ниво, тј. кад се корист/добит лопова изједначи са штетом жртве. Закон, међутим, кажњава сваки ниво пљачке чак и кад је она социјално праведна.*

**Кључне ријечи:** *ефикасност, праведност, гранична корисност, гранична штета, корист лопова, штета зртве, оптимални ниво пљачке, економска теорија, закон*

**ЈЕЛ класификација:** *A1, D63*

## 1. INTRODUCTION

The article analyses theft as an economic and social activity. The article challenges conventional attitude to theft as repulsive activity which causes moral indignation.

Theft is analysed through two criteria which economists usually use when judging any economic activity; efficiency and equity. In addition to these two criteria a third one is introduced, namely the optimal level of theft.

Theft passes the test of equity since in a vast majority of cases it redistributes income from the wealthier to the poorer. It is justified from the point of view of economic theory when thief's gain exceeds victim's damage, i.e. before the optimal level of theft is reached. Still, any theft is considered illegal.

On the other hand there are many activities which do not create any value, and which are neither economically efficient nor equitable (just) and which are in spite of this perfectly legal, although they might be morally repulsive. The article emphasise a friction between economic theory and law.

## 2. ECONOMIC THEORY AND THEFT

I asked several economists the following question: "Why is a bank robbery illegal in the USA?". Their first reaction was as if I was joking. When I persisted to extract the answer from them they got the impression that the question was eccentric and that does not deserve any attention. I persisted and tried to elaborate my question. In a society in which the main aim of economic activity is not the creation of material, intellectual or spiritual values but rather making and if possible maximising profit a bank robbery is justified from the point of view of economic theory so long as marginal revenue exceeds marginal costs. So long as the amount of stolen money is greater than the costs of vehicles, equipment and robbers' wages the operation is profitable and therefore justifiable from the point of view of economic theory. Only when the law of diminishing returns is set in motion, when robbers move from big to small banks and when marginal costs start rising and eventually exceed marginal revenue, is bank robbery not justifiable. Mathematically it looks like this:

**$MR \geq MC$**  – Theft justified

**$MR < MC$** - Theft unjustified

After this explanation followed the answer that apart from possible violence which accompanies robbery there are two reasons why robbery is illegal: 1. Damage inflicted on a victim of theft 2. Forced redistribution of income.

Economists considered both aspects of theft.

1. It is a common opinion that a damage which the victim of theft suffers is the only reason of its illegality. Damage is increasing with the rise in the level of criminal activity. Using mathematical symbols it could be represented in the following way:

$$D_i = D_i(A_i),$$

With

$$D'_i = dD_i/dA_i \geq 0,$$

Where  $D_i$  is a damage caused by the  $i$  activity and  $A$  is the level of that activity. This concept is closely linked with external diseconomy, where the rising level of activity leads to an increase in damage.

A damage caused by a theft should, however, be compared with the gain acquired by a thief, which also increases with the level of activity.

$$G=G(A)$$

With

$$G'=dG/dA \geq 0$$

Net costs, i.e. the loss which society suffers is the difference between damage and gain and it could be represented as

$$L(A) = D(A) - G(A)$$

With increase in the level of activity the gain of delinquent is subject to the law of diminishing returns ( $D'' \leq 0$ ) while the damage which the victim suffers rises ( $D'' \geq 0$ ). This could be expressed as

$$L'' = D'' - G'' \geq 0$$

The optimal level of theft is achieved when  $L'' = 0$ , i.e. when  $G'' = D''$ . Until that level is reached the authorities should tolerate theft. They should intervene only when the total loss is positive (Baker 1968, 169-217).

In his Nobel Lecture Gary Becker mentioned economic treatment of theft: "In the early stages of my work on crime, I was puzzled by why theft is socially harmful since it appears merely to redistribute resources, usually from wealthier to poorer individuals. I resolved the puzzle by pointing out that criminals spend on weapons and on the value of the time planning and carrying out their crimes and that such spending is socially unproductive – it is what is now called "rent seeking" – because it does not create wealth, only forcibly redistributes it. (Baker 1993, 8)

Economists judge every activity through two criteria, *efficiency and equity*. They don't feel any moral indignation when theft is mentioned, since it only redistributes income from wealthier to poorer. Theft, therefore, passes the test of equity. What concerns economists is that huge resources, talents and creativity are wasted on unproductive activity which does not create any value. The main objection economists have is that theft does not pass the test of efficiency.

### 3. REDISTRIBUTION OF INCOME IN HOUSING MARKET

Many activities and events lead to legal redistribution of income and resources. Changes in growth rates, rates of inflation, tax rates, interest rates and exchange rates redistribute income, sometimes from wealthier to poorer, sometimes from poorer to wealthier. The largest distribution of income and wealth occurs in property market and stock exchange market.

In principle there are three ways how people can secure roof over their heads. First is by renting a house, a flat or part of it from a private landlord. The second one is by getting a council flat or a flat or house owned by a housing association. The third one is by buying own property.

Renting from a private landlord is usually considered a temporary solution. This option is the most unfavourable one since the money paid to a landlord is "sunk" money. Apart from that subtenants do not always have a full freedom in using the property they rented.

The second solution does not involve any risk and is economically most favourable since rents paid to non-profit owners, such as housing associations, are far below the market price. However, a supply of flats and houses owned by non-profit organisations is limited, while demand is high. As a result individuals and families must wait for many years.

The third solution is therefore the most desirable. A vast majority of people cannot afford to make an upfront payment for the property they want to purchase. They must get a mortgage from the bank or some other financial institution.

Banks and other financial institutions, before lending money to applicants, ask for a fulfilment of certain conditions. One of them is a payment of part of applicant's capital in a form of a deposit. In this case the main accounting equation looks like this:

$$A = C + L$$

where A represent assets, C capital and L liabilities.

If, for example, the price of a house is 100,000 euros, and required deposit is 10%, the accounting equation will look like this:

$$100,000 (A) = 10,000(C) + 90,000 (L)$$

A buyer will have *positive equity* a positive net value of 10,000 euros, as a difference between the price of a house and the money owed.

If financial institutions do not require deposits the main accounting equation will look like this:

$$A = L$$

The buyer will become the owner of a house but will owe to a financial institution the amount of money his house is worth. In this case equity (a difference between the value of a house and debt) will be zero.

House prices, as most other prices are determined by demand and supply. Demand for property is determined by many factors such as income, availability of credit, required deposit, interest rate etc. If demand for property falls prices will decrease and the owner of a house will be caught in a negative equity. However, house prices more often rise. If a house price increases to 200,000 euros the owner of a house will have a positive equity of 100,000 euros. The real value of the house will fall due to depreciation but the price will be twice as high as the initial one. If the owner decides to sell the house they will appropriate a capital gain of 100,000 euros although no new value has been created. A sale of the house will pass the equity criterion if the buyer of the house is wealthier than the seller. If the seller of the house is wealthier than the buyer wealth will be redistributed from the poorer to the better off.

#### 4. REDISTRIBUTION OF INCOME IN FINANCIAL MARKETS

Redistribution of income in a property market is by far exceeded by the redistribution of income in financial markets, especially in stock market. Buying shares could be a form of saving or a medium of speculation. In both cases shareholders aim to maximise the shareholders' value. The shareholders' value consists of two components; dividends and capital gains. Dividends are part of profit appropriated by shareholders. Capital gains are the difference between selling and purchasing price of shares. If a shareholder buys 1000 shares for 5 euros apiece and if share prices increase to 10 euros apiece they can acquire a capital gain of 5000 euros by selling their stock of shares.

However, if a company performs badly share prices can fall. If share prices decrease from 5 euros to 2 euros the shareholder will suffer a capital loss of 3000 euros. If a person decided to buy shares for the sake of saving or speculating one cannot talk about unjust redistribution of income. That person could have chosen a safer form of saving, for example saving in banks or buying government bonds. Using examples from The Great Depression John Maynard Keynes compared a stock exchange with casino. He drew a conclusion that most of people should be banned from entering casino or accessing stock exchange due to potentially catastrophic effects which these two institutions can engender. One could talk about unjust redistribution of income only if people do not have a choice and must buy shares. For example, some employees of private companies in the UK could have invested only in private pension funds. Managers of these funds gambled on the stock exchange expecting to maximise the yield. After these companies collapsed people in their fifties and sixties were devastated

when they learned that shares in which they invested 100,000 pounds over decades were worth only 4000 pounds.

Unlike ordinary shareholders successful stock exchange speculators must possess knowledge, intuition and creativity. In the same way an excellent poker player can sometimes lose a big amount of money a brilliant stock exchange speculator can sometimes suffer great losses. When the British pound left the ERM (Exchange Rate Mechanism) in 1992 George Soros earned a several hundred million pounds, but lost a double amount during the Russian financial crisis in 1997. However, in the long run as in the case of excellent poker player, gains of a successful stock exchange speculator will by far exceed their losses.

George Soros claims that his remarkable successes in the stock exchange have a philosophical background. They are rooted in a concept of reflexivity, which he derived from Karl Popper's philosophy and critics of logical positivism of Russell, Wittgenstein and Ayer. From this concept he also derived a critic of a neoclassical economic theory which drawing analogy with physics teaches that all markets are self-regulating and tend toward equilibrium.

"The first part of my critique concerns the inherent instability of the global capitalist system. Market fundamentalists have a fundamentally flawed conception of how financial markets operate. They believe that financial markets tend toward equilibrium. Equilibrium theory in economics is based on a false analogy with physics. Physical objects move the way they move irrespective of what anybody thinks. But financial markets attempt to predict a future that is contingent on the decisions people make in the present. Instead of just passively reflecting reality, financial markets are actively creating the reality that they, in turn, reflect. There is a two-way connection between present decisions and future events, which I call reflexivity.

The same feedback mechanism interferes with all other activities that involve cognisant human participants. Human beings respond to the economic, social and political forces in their environment, but unlike the inanimate particles of the physical sciences humans have perceptions and attitudes that simultaneously transform the forces acting on them. This two-way reflexive interaction between what participants expect and what actually happens is central to an understanding of all economic, political and social phenomena. This concept of reflexivity lies at the heart of the arguments presented in this book (Soros 1998, xiii and xxiv).

One of the main features of information coming from the markets is their asymmetry. It is much more pronounced in stock market and in goods markets. Access to information is very often vital in acquiring wealth through a radical redistribution of income. Excellent example for this is an episode related to the rise of Rothschild financial dynasty.

Even before the Napoleonic wars Nathan Rothschild was a shareholder of the Bank of England. He saw a battle at Waterloo, which took place on 15<sup>th</sup> June 1815. Being sure who won the battle he rode his horse full flat to Ostend, where he paid a fisherman an exorbitant sum of 2000 francs to take him to Dover in gales and high waves. On 16<sup>th</sup> June in the morning hours he was lying between the columns of the Central Bank of England giving the impression of a broken man. He instructed his agents to start selling the Bank's shares in order to "prevent disaster" as much as it was possible. This happened after he spread the news that Napoleon had won. In the coming two days rumours circulated London that the Prussian general Buchler surrendered and that the admiral Wellington left the battlefield, unable to withstand the overwhelming Napoleon's force. Apart from gloomy atmosphere these rumours caused a spectacular fall of the Bank of England's share prices. On 20<sup>th</sup> June, five days after the battle, the news that Napoleon surrendered reached London. Apart from jubilation the news prompted enormous rise in share prices of the Bank of England. Many felt sorry for Nathan Rothschild that he had started selling the shares too early. They did not know that on 19<sup>th</sup> June, when the share prices reached the bottom he instructed his secret agents to start a wholesale purchase of the shares (Thompson 1994, 148-149).

Nathan Rothschild, probably the richest man in the world at the time, died from an ordinary infection in 1836 (Kay 2003, 30) without creating any new value or increasing economic efficiency. But the way he earned his fortune could not be qualified as socially unjust. Shareholders of the Bank of England, on whose expense he earned his wealth, could have hardly been called poor. In this case the redistribution of income went from the wealthy to the wealthy.

From the Napoleonic wars until now the economies of the most developed countries grew by more than 30 times. That exponential growth was accompanied by strong expansion of financial markets, their increased complexity and higher sophistication of financial inventions and instruments, culminating in creation of so called derivatives in recent times. From the Great Depression until

1970's financial markets were put under control. Deregulation of economic activity which then started released the monster from the cage enabling speculations of unimaginable amount and leading to huge distribution of income from the poor to the rich. This trend has been intensified in the USA after 1999 when president Clinton reluctantly signed the repeal of Glass-Steagal law from 1933 which separated commercial from investment banks. Speculations and gambling in financial markets have intensified leading to a bubble burst in information technology market at the beginning of this century and in 2007 to a bubble burst in the housing market. This was a prelude to the Great Recession and a massive redistribution of income from the poor to the rich.

The property market in the USA experienced changes in the second part of 1990's when the then president Bill Clinton and Roberta Achtenberg, a deputy minister for urban development embarked on essentially a well-intentioned campaign whose aim was to spread a homeownership amongst lower income earners by making mortgages more affordable. (detailed in McDonald and Robinson 2009) Bankers grabbed the chance to earn billions of dollars of profit, and various agents to increase its wealth by pocketing millions of dollars in bonuses as a reward for massive selling mortgages. Normally mortgage applicants must fulfil certain conditions such as a proof of stable and secure employment, a level of income and savings with which they could prove their ability to pay deposit and instalments. The main feature of a new environment, however, was the state humorously named *no.doc.*, meaning without documents. No proofs were required to get a mortgage. Janitors declared a monthly salary of \$10,000 and bus drivers a monthly salary of £33,000. Bank managers and mortgage sellers would put money into the clients' accounts, photocopy a report and then withdrew the money from their accounts, so that they would have a proof about savings. Mortgages very often amounted 110% of the house price. If the average house price was £300,000 the mortgage would amount to £330,000. In the first two to three years a so called teaser interest rates of 25 were applied making an instalment a negligible proportion of clients' income. In a situation of huge demand for houses and an exorbitant rise in their prices, a new concept of negative amortization of mortgage was introduced. In normal contracts debtor must repay every month part of a principal and part of interest, so that amount of debt decreases over a period of time. The new financial arrangement meant that debtors repaid only part of interest and not a principal. This meant that a total debt increased. But, this was not a cause for concern for new "homeowners" since financial agents explained to them that house prices were constantly rising absorbing increased debt.

And house prices soared. In 2002 they rose at the rate of 10%, and in the next following years at the rate of 12.5%. But in some parts of the country, in Florida and California for example, they increased by 33% and in Stockton, the area with highest percentage of illiterate in the USA, by 50%.

A frenzy activity in the housing market was accompanied by a new financial innovation CDO (collateral debt obligation) where a property was used as the collateral. Trillions of dollars of this financial instrument were issued assuming that they are covered with ever rising house prices, whose value reached 23 trillion dollars in the USA. These papers were traded around the world ending up in London, Paris, Shanghai and Hong Kong. Banks and newly established shadow banks earned tens of billions of dollars in profit and financial agents received tens of millions of dollars in "well deserved" bonuses. Mortgage industry became so lucrative that even General Motors penetrated the market by establishing a special branch which issued mortgages. In an environment of general euphoria it looked as everybody was happy; banks because of exorbitant profits, financial agents because of multimillion bonuses, financial assets owners because of high yields which sometimes exceeded 10% and "house owners" because of unbearable lightness with which they acquired property. Financial agents would very often celebrate their successes in luxurious New York restaurants where dinners cost \$ 1000 per person and where waiters received tips in excess of \$100.

The situation has started to change drastically in 2006 when according to mortgage contracts, which many clients did not understand, teaser interest rates increased five-fold. Monthly instalments soared from bearable \$800 dollars to \$2400 and in some cases from negligible \$400 to \$2500. Faced with such calamity many "house owners" decide to leave houses and return to semi-ghettos where they came from.

A wave of bankruptcy in the property market quickly spread to financial markets. Without collateral share prices plunged (sometimes from \$85 to 30 cents). Debts of banks and big companies soared. Lehman Brothers, for example accumulated debt of 660 billion dollars, which was 44 times greater than the value of its assets. The total "value" of financial instruments rose to 70 trillion dollars, five times USA GDP. Debt could have decreased only by a massive sale of financial papers, but nobody wanted to buy them.

Huge redistribution of income from the poor to the rich did not comprise new “house owners”. They got temporarily something they did not deserve. Due to their ignorance and gullibility they were deceived by promises that they can easily achieve “the American dream”. Those who became the victims of socially unjust redistribution of income could be classified into three groups: 1. Pensioners, which funds were decimated, 2. Old house owners, who after the collapse of the housing market and fall of house prices by 33% were caught in negative equity and 3. Those who lost their jobs in coming recession.

How did things fair from the point of view of economic efficiency? Expansion “on steroids” increased growth rate of the American economy by 50%. Since the American economy grew at the average rate of 3% from 2002 to 2007 an artificial growth amounted to 1%. American GDP is about 15 trillion dollars, and 1% is therefore around 150 billion dollars. After the credit crunch the American economy for several years created GDP which was a trillion dollars a year below its potential. (Krugman 2012, 14) This means that the whole operation in the housing market led to catastrophic consequences from the point of view of economic efficiency.

One channel of redistribution of income from the poor to the rich was open by a series of accounting techniques and operations, morally repulsive, but legally acceptable, comprised under the name of creative accounting. One of the techniques of creative accounting includes recording a loan as a profit. The following simplified example will show the application of this technique:

A company A establishes a non-existing company B. The non-existing company B obtains a loan from the bank in order to buy equipment from the company A. The company A “sells equipment” to the company B, which increases its revenue by the amount of the loan. Since this transaction does not involve any costs total revenue equals profit. Instead to record the loan as a liability in the balance sheet the company A records the loan as a profit in the profit and loss account.

Increase in profit leads to a rise in share prices, for example from \$3 to \$10. Chief executives of the company A buy shares at \$3 dollars apiece. Being aware that shares are overvalued they start to get rid of them by a massive sale in the stock market at the price of \$10, appropriating millions of dollars in capital gains. Increased supply of shares lowers their price, for example from \$10 to \$6. This and similar operations decimated pension funds and in spite of rise in house prices in 2002 1.6 trillion dollars were wiped out from their balance sheet. (detailed in Stiglitz 2003, 115-147)

Apart from socially unjust redistribution of income irresponsible gambling in financial markets creates huge debts, which amount to a several trillion dollars. Who pays these debts?

I am a bad poker player. But even with best professional players I might win one in ten games, if I am lucky to get good cards, following the law of average. In this case profit is mine, it is private. In remaining nine games I will lose and suffer a financial loss. But I am not concerned because of those losses. It pays to me to play even if I lose because I have a great advantage. I have a rich daddy. Whenever I lost money in a poker game my daddy will pay for it. But I will not tell my daddy exact amount I lost. If I lose 200 euros I will tell my daddy that I lost 500 euros. My daddy will give me 500 euros to pay my gambling debt. In case of my losses in poker games they are familiarized. This leads to a moral hazard, where irresponsible gambling and taking a risk pays since freedom is not accompanied with responsibility.

Above described events are occurring with gamblers in financial markets. When they earn profit it is private, when they record losses, they are socialised.

Who is a rich daddy of gamblers in financial markets? It is state/government which pays gambling debts worth several trillion dollars with taxpayers’ money. “All my life I’ve been a laissez-faire Ronald Reagan/Margaret Thatcher capitalist, swearing by the market, taking the risks and the devil take the hindmost. But this one time I was looking for a government rescue and I wasn’t going to get it” (McDonald and Robinson 2009, 323).

Milton Friedmann, a spiritual and intellectual father of Reagan/Thatcher laissez-faire capitalism wrote in his letter to Augusto Pinochet in 1975: “The major error, in my opinion, was to believe that it is possible to do good with other’s people money” (Klein 2007, 18).

And although there are rich among taxpayers they nevertheless make a minority. A vast majority of taxpayers belong to a lower or middle class. A colleague of mine told me during a teachers’ strike: “Congratulations. They announced in the morning that you gave Richard Branson, a billionaire and the owner of the Virgin Company, 130 pounds”.

These examples lead to paradoxical, absurd conclusions. Police will prevent any theft if it can in spite of the fact that it is socially just in a vast majority of cases. It will react even if the gain of a thief exceeds the loss of a victim of the theft, in other words before the optimal level of theft is

reached. Police is, however, completely inert when faced with activities which do not create any value, which are disastrous from the point of view of economic efficiency and which unjustly redistribute income.

Apparently there is a friction between economic theory and law. Either something must be wrong with economic theory or something is wrong with law, or perhaps something is wrong with the both. Perhaps the explanation of this absurd could be found in Montesquieu's words that law is a net through which big fish pass and on which the small ones are caught.

## 5. CONCLUSION

In a vast majority of cases theft redistributes income from better off to worse off; therefore, theft passes the test of equity. Also, at lower levels a thief's utility exceeds the damage which a victim of theft suffers. As levels of theft increase, marginal utility to a thief falls and marginal damage to a victim of theft increases. Optimal level of theft is achieved when marginal utility to a thief equals marginal damage to a victim of theft.

Economists do not feel any moral indignation to theft since it passes the test of equity. What concerns economists is the fact that theft is unproductive activity which does not create any new value. Theft, therefore, does not pass the test of efficiency.

Theft is analysed and compared with several economic activities which do not create any material, intellectual or spiritual value and which pass neither the efficiency nor the equity test. Those activities might cause moral indignation but are perfectly legal.

Economists can justify theft until optimal level is reached, i.e. when the thief's utility is equal to the damage suffered by a victim of theft. Laws, however, punish every theft even when it is socially just.

Apparently, there is a friction between economic theory and the legal system. Something must be wrong either with economic theory or with the law. Or maybe both of them are wrong. A possible explanation might be found in Montesquieu's statement that the legal system is a network through which big fish pass and small fish are caught.

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