

**Boris Begović**

University of Belgrade,  
School of Law,  
Serbia  
✉ begovic@ius.bg.ac.rs

# Termites of the State: Why Complexity Leads to Inequality

by **Vito Tanzi**

Cambridge University Press, 2018.

Expectations cannot be exaggerated when an economist with a long and eventful career, a no-nonsense person with full hands-on engagement in dealing with fiscal issues for decades, including as director of Fiscal Affairs Department of the International Monetary Fund and a thinker with a sharp analytical mind, publishes a book that, at least according to the title, deals with the state. Vito Tanzi, just such an economist, recently published such a book, with the seducing title *Termites of the State: Why Complexity Leads to Inequality* and the reader cannot help but immerge himself/herself into the publication with eyes wide open and mind set on sheer intellectual pleasure. Furthermore, the author specifies in the Introduction that: “The book covers various areas not covered by other books. It provides arguably the most detailed anatomy of the public sector available...” (p. 10). None can blame the reader who expects a thunderstorm of insights and ideas about the state and, especially its termites – the mysterious creatures that undermine it.

Nonetheless, very soon the reader realises that we live in uncertain world and that reputation, though it is a credible signal, is not necessarily a true one. Never mind the accuracy of the quoted sentences in the Introduction of the book. Perhaps what the reader is dealing with is termites of the book rather than termites of the state. For the beginning, one of the termites is that the reader cannot get information what, according to the author, is the aim of the book until one of the last chapters of the book, at page 314 (*sic*): “In this book I refer to recent factors that may contribute to the pessimistic view of the economic role of the state as a termite of the state, arguing that these termites are making that role more difficult to implement at a time when, to some observers, the government role might appear more needed than in the past because of problems that have developed in the private market”. Let alone the phrasing “to some observers”, repeatedly used throughout the book.

The book is divided into three parts and 34 (*sic*) chapters, some of them containing only four pages. Part I, “Changes in the Economic Role of the State in the Twentieth Century” deals with the history of economic thought more than economic history. It is a description rather than an analysis of what was going on in both fields,

specifying that in the mid-1960s economists found nirvana by applying Keynesian theory and the development of welfare state ostensibly on that theory. Then, according to the author, “barbarians” appeared at the gate to challenge that nirvana, with rather barbaric tools: public choice theory, rational expectation theory, efficient market hypothesis, Ricardian equivalence hypothesis, etc. The barbarians were successful and, according to Tanzi, market fundamentalism triumphed. For the author, this fundamentalism is a religion, “a different but similar kind of religion, *faith in the free market*” (p. 78, italics in the original). Similar to the Bolsheviks’ religion and their faith in communism and abolishment of the markets, according to Tanzi. If only Bolshevik academic economists had produced their equivalent of public choice theory or rational expectations theory.

It is evident that Tanzi does not subscribe to Keynesianism, emphasising that the overwhelming importance of the short-run creates and aggravates problems in the long-run. He rather subscribes to the insights of possibly the two greatest doctrinal adversaries of Keynesianism. The first one is Milton Friedman with his views of the populist potential of Keynesianism, claiming that everyone, both consumers and government, should indulge in consumption. The more they consume, the better it is; in short, thrift is vice. As a comment on Keynes’ frequently quoted statement “in the long-run we are all dead”, Tanzi quotes the second one, Ludwig von Mises (2005) and his memorable response “nearly all of us outlive the short-run and ... spend decades paying for the easy money orgy of a few years” (p. 71).

The problem, according to the author, is that “the religion of market fundamentalism was based on highly theoretical and abstract economic analyses, at times undertaken by individuals who were able to use advanced mathematical tools” (p. 79). Tanzi cites Paul Romer (2015) and his criticism of “mathism” to corroborate this insight. There are three problems with Tanzi’s insight. The first one is that it is not true: a free market stance, which would be a rather more accurate description of the author’s notion of “market fundamentalism”, was based on theoretical insights, e.g. public choice theory, which are not at all mathematised, as well as empirical findings, case studies or anecdotes within the framework of the government failure concept, which can hardly be mathematised. Second, the criticism in Romer (2015) focuses on the accomplishments of economic growth theory, or rather the lack thereof, due to extensive mathematization, not on the public policy impact of economic theory. The third and most important problem is that the author does not offer any explanation why in the late 1970s free market ideas won the battle of ideas against the ideas of extensive government intervention, or Keynesianism, since it is considered the academic equivalent of that intervention. There is not a single word of the stagflations that dominated the 1970s and the inability of the Keynesians to provide an adequate cure for it or the inefficiency of the public sector, let alone for public frustration regarding widespread industrial actions. If Tanzi’s book was the only input for consideration, the conclusion would be straightforward: propensity to a free market stance, or “market fundamentalism” as the author has put it, came out of the blue. That is hardly true. Furthermore, it contradicts a “conspiracy” theory that the author subscribes to a few chapters later, that the deregulation and “market fundamentalism” advent was due to the rich favouring deregulation and lower taxes, for their own interest, “*especially in the areas in which*

*they operate*” (p. 154, italics in the original). The rich have existed and were active during the Keynesian nirvana, yet no deregulation occurred.

The other controversy centres on the meaning of “market fundamentalism”, since Tanzi takes it to mean that: “Society moved in the direction of becoming a *market-ruled society*, rather than a *community of individuals* who would give importance to various nonmarket exchanges among its members, and in which money should not play a dominant role in *some* relations” (p. 81, italics in the original). The support for this insight is provided in Michael J. Sandel (2012) through anecdotal evidence that people are no longer writing Christmas cards themselves but send a list of addresses to private companies to do it for them professionally. Well, conventional wisdom is that “market fundamentalism” is about public policies aimed at reducing government intervention to a minimum<sup>1</sup>. Nonetheless, for Tanzi it is about the people’s preferences. Well, it is legitimate to consider market fundamentalism that way (although for academic economists, preferences are exogenous), but it is not the best approach for examination, both positive and normative, of the role of the public sector.

The final chapter of the Part I, “A Minimum Economic Role of the State”, offers Tanzi’s insight that, because of externalities and the increased complexity of humane interactions, informal rules must be substituted by formal, government supported rules that will “benefit the community *as a whole*, and to avoid potential conflicts between community members” (p. 91, italics in the original). The author considers these rules to be restrictions on the freedom of some members of the community, illustrating this approach with the example of speed limits, which restrict the freedom of those individuals who like to drive fast. The problem with this insight is that rules restrict freedom – negative freedom, in the sense of Isaiah Berlin (1969) – of all the people, irrespective of their preferences. Tanzi is wrong. Rules are public goods – the costs of exclusion are prohibitively high.

The other conceptual problem of the book is related to institutions. Tanzi considers desirable institutions to be those that: “regulate, register, and, when necessary, enforce the contact. A world without such institutions is less likely to be a desirable world. The institutions can be private ones, but increasingly individuals and communities have preferred public ones” (p. 93). Notwithstanding the evidence of the shift in preferences, it is now evident that Tanzi is not referring to institutions, but to organisations according to Douglass C. North (1990) and his seminal and generally accepted contribution to institutional economics. This confusion is not helpful for the reader who tries to understand the pros and cons of government intervention. Furthermore, the reader is not given any clue about that in the chapter titled “A Minimum Economic Role of the State”.

Part II of the book, “Complexity and the Rise of Termites” is the central section of the book, by sheer volume if not by other criteria. At the beginning of this part Tanzi lays down his methodological cards regarding the analysis of the public sector. After downplaying the insights of School of Public Choice and Chicago School, he specifies that: “The description shall be based largely on direct observations, minimizing reliance on armchair theorizing, which tends to be more easily influenced by personal

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<sup>1</sup> Tanzi fortunately avoids using neologism “neoliberalism”, so dear to the many non-economist observers of the contemporary world.

biases and preconceived views” (p. 110). Well, notwithstanding that the reader of the book written by someone like Tanzi is definitely more interested in analysis than in description, “direct observations” are also influenced by these biases and preconceived views, at least to the same extent as theorizing, in an armchair or elsewhere.

Fortunately for the reader, the book does not contain only descriptions. Tanzi points to the problem of “public interest” as a benchmark for valuation of the regulation, which he points out is too excessive these days. The problem is that contemporary societies and constituencies are more heterogenous than before, not only in ethnical terms, but also in terms of gender, education, preferences, and with rising life expectancy in terms of the distribution of age. Hence, with all these specific and sometimes conflicting interests of so diverse social groups, it is much more difficult to identify public interest. This is bad news for the pro-regulation freaks, the reader concludes.

Nonetheless, Tanzi advocates that more advanced, more heterogenous, and more complex societies, i.e. modern societies “are likely to require *more* and *more-precise* rules for their members because traditional norms may guide their behaviourless” (p. 132, italics in the original). Considering financial markets, Tanzi is even more straightforward: “*More complexity justifies more governmental intervention*” (p. 156, italics in the original). Notwithstanding how convincing these conjectures are, it is rather strange that their author complains about how extensive contemporary regulations are (more than 168,000 pages in the US, p. 126) and how complicated they are; they simply have to be for such societies. Tanzi complains that regulations that “have increasingly been written by lawyers for lawyers, changing the ‘rule of law’ into a ‘rule of lawyers’” (p. 273). But such a development was quite expected – simple rules for more complex societies is not a consistent proposal.

Furthermore, in another section of the book Tanzi suggests that the government should “*intervene to make the market function more closely* to the way that an efficient market ought to function” (p. 229, italics in the original). The reader has no other choice than to consider this as a call for deregulation – the call for less rather than for more government intervention. Such an attitude on the part of the reader is reinforced by Tanzi himself: “In some sense it might be argued that this was the real call of the so-called Washington Consensus” (p. 230). Now, the reader has a problem: which Tanzi should he/she believe? The one advocating more government intervention or the one supporting the Washington Consensus? Or perhaps the one who specifies that “libertarian aspiration suffer from lack of realism, because these libertarians would like to live with rules that are no longer appropriate for today’s world” (p. 254)? Maybe he/she should believe the Tanzi who boldly, without any evidence, but perhaps under Sergio Leone’s influence, specifies that: “A world with too few regulations may not become a free and efficient world, as some claim, but may come to reflect the environment shown by movies about the American West, when the fastest guns won the short-run fights, and the fastest guns were not necessarily on the good side” (p. 283). The termites of the book are working overtime.

The concise inventory of government tools provided by the author is very useful. He points out that contingent liabilities is a modern instrument of great and growing importance, so these insurance schemes are thoroughly analysed: deposit insurance schemes, PPP revenues guarantees, housing finance markets insurances (*à la* Fannie

Mae and Freddie Mac), including the “too big to fail” syndrome, so prominent in the 2008 financial crisis, etc. Not only did various insurance schemes, especially vulnerable to catastrophic events, create massive contingent liabilities, but they also produced moral hazard on a vast scale. Tanzi has no second thought: “Contingent liabilities have become a major termite (of the state)” (p. 139).

The author is critical of the government that recognises the need for new regulations “only *after* major problems have developed or disasters have occurred that might have been avoided by the timely existence and enforcement of some regulation” (p. 172, italics in the original). The reader would expect at least a discussion of the informational problem of the *ex ante* approach to regulation design, especially since the author emphasises that there is much uncertainty about the impact of some regulations, but the discussion is absent. Tanzi advocates a formal process in which regulations should be reviewed at regular intervals by a competent, responsible and independent institution “a kind of supreme court for regulations” (p. 172), but what is missing from this proposal is a political economy analysis of the framework within which inevitably a political decision on the establishment of such an authority would be made.

Tanzi’s discussion of the issue of public good is linked to one of the central topics of his book: intellectual property rights protection. The deliberation starts smoothly, by pointing out the main insight of the optimal supply of public good theory, but then an interesting notion appears. The author thinks that in modern times public goods are not entirely public, but partly private, and his expert witness for this insight is none other than US President Dwight D. Eisenhower who “had warned about the existence of a military-industrial complex that in his view was pushing for more military spending and was, as a consequence, transforming a pure public good, at least in part, into a private good” (p. 178). The problem with this statement is that increased military spending, whatever the source of that increase may be, does not transform national defence into a private good – it is still a pure public good in terms of zero marginal costs for additional user and prohibitive costs of exclusion. The debate can be about the optimal level of provided public good, i.e. whether there is too much national defence, or efficiency of that provision, i.e. whether national defence is too expensive, but the national defence is undoubtedly a pure public good, irrespective of the outcomes of the discussion.

The problem of wrong perception of public good is augmented in the case of public financing of fundamental research. There is no doubt that the results of this research – breakthroughs in general knowledge, i.e. information published in academic journals – are pure public good. It is evident, as Tanzi points out, that companies and individuals apply that new knowledge in their research and development to produce innovations that can be protected by patents and in that way create (temporary) monopoly rent. The problem emerges with Tanzi’s insight that: “Spending money for fundamental research is one of several examples where society pays the costs and *particular* individuals, rather than the *whole* of society, end up receiving many of the benefits” (p. 180, italics in the original). This is simply not true. It is consumers, i.e. the *whole* of society, that receive benefits of the technological progress and innovations that are based on the improvement of the general knowledge funded by public money, both

during the term of patent protection and after it. The insight that the patent holders appropriate monopoly rent does not preclude the increase in consumer surplus due to technological progress. On the contrary, it is a dynamic interaction between patent-created rents, technological progress due to the research and development that is funded from those rents, and the increase in consumer welfare that are important. Removal of one building block undermines the entire structure. It is very unfortunate that this interaction, which is at the bottom of the protection of intellectual property rights, has not been considered in the book that is so critical towards that protection.

Income distribution is an omnipresent topic in the book. The problem is that its consideration is scattered throughout the chapters and parts of the book. Tanzi is consistent in his views on the issue, but the cost of that consistency is the repeating of the same insights and arguments. One of the main points is that the government influences market distribution of income and that a change of that influence would also change both pre-tax and pre-transfer income distribution. Tanzi identifies seven government policies, for example, protection of the property rights, which in his view influence the market distribution of income. In summing up, the author points out that: “To repeat, the various government rules, created over many years, play a significant role in determining the market’s distribution of income, *before taxes and public spending enter the scene*” (p. 198, italics in the original). Tanzi refers to it as the *invisible hand of the government*, though the reader might wonder what is invisible in, for example, the protection of property rights: highly visible laws, highly visible police and judiciary who provide it; the hand of the government must be heavy and visible to make an impact. One way or the other, the author is explicit about it: “If it were possible to reduce, or to eliminate, the *ex ante, invisible hand of the government*, a less-explicit *ex post* redistributive role might be necessary” (p. 199, italics in the original). The problem with this approach is that it does not take efficiency into account at all: there is no examination of the consequences that changing rules, which would make income distribution more equal, would have on efficiency. Perhaps loosening protection of property rights, especially intellectual property rights, would make income distribution more equal, as implicitly suggested by the author, but the consequences of such a change on the sheer volume of production, i.e. income, are neglected. Focusing exclusively on the way the cake is divided, Tanzi disregards its size.

The issue of income distribution reappears in the book within the framework of absolute *versus* relative poverty discussion. Tanzi has no second thoughts: “psychologically ... *relative* poverty can be as damaging as *absolute* poverty” (p. 216, italics in the original). The reason is – envy. It is not important, the author suggested, whether we like it or not, and also not important whether we continue to consider it as a vice, “Envy is likely to create resentment and psychologically based negative feelings” (p. 217). For Tanzi, envy in some circumstances is “normal or understandable” (p. 321) and creates negative externalities – psychologically based externalities that attention ought to be paid to. Notwithstanding the theoretical ground to proclaim that envy creates externalities, the author has great understanding for envy and, because it has been labelled as negative externality, there should be a government intervention in connection with it. Perhaps the solution would be to go back in time to the Stone Age egalitarian society in which envy was reduced to a minimum. Perhaps the solution could be

to revisit Pol Pot's Kampuchean experiment in which envy was not a problem – everything else was.

Tanzi specifies that the source of increased inequality is government policy: "... in the last four decades the economic role of the state has become more favorable toward high-income groups and less favorable especially toward the middle classes, with more uncertainty about what has happened to those in the low percentiles of income distribution" (pp. 221-222). Therefore, it is not about technological change and its effects on inequality, so well characterised in literature (Barry Eichengreen 2018), nor is it about globalisation and its effects on inequality, also well demonstrated in literature (Robert Baldwin 2016): it is about government policy, meaning that everything can change with the change in government policy. According to Tanzi, the main features of the government policy are: (a) cronyism; (b) increased protection of intellectual property rights; and (c) changes in the tax system. The author believes that cronyism and other termites of the state "were made possible by increasing complexity in government and market operation" (p. 222), as if cronyism did not exist in times of simplicity of both government and market operation. By emphasizing intellectual property rights, Tanzi refers to the temporary market power created by that protection and its effects on increasing inequality. Nonetheless, contemporary contributions to industrial organisation (Daniel A. Crane 2016) have demonstrated that there is no unambiguous finding regarding the causality from market power to inequality. Finally, changes in the tax system are, as demonstrated by Branko Milanović (2016), an inevitable consequence of globalisation, increased international capital mobility and tax competition. None of these issues have been mentioned in Tanzi's book.

Perhaps the most interesting part of the book is Tanzi's proposal for improving the income distribution of a country. It is entirely an *ex post* approach aimed at avoiding the "poverty trap", a situation in which transfers solely to the poor undermine incentives for recipients to improve their situation through their own effort, since such an improvement would put an end to such transfers. The proposal is straightforward: proportional or "reasonably" progressive taxing of the income of all citizens, with part of the revenue, presumably the one that remains after funding the provision of public goods, being transferred "to all citizens, rich and poor, in equal, absolute amounts, leaving to them the freedom to spend the money received as best as they wished" (p. 210). By and large, this is universal basic income, though the author does not use that term.

In addition to solving the "poverty trap" issue, this proposal would undoubtedly simplify tax regulations and streamline tax administration. Tanzi points out that this flat tax – a basic income scheme – should replace virtually all other redistribution mechanisms and it should not be used as an additional one, like the proposal put to referendum in Switzerland several years ago. The proposal is consistent and efficient. What is missing is a simple back-of-envelope calculation of the tax burden increase needed for a substantial redistribution under this scheme. It is evident that: "The higher the share of total income collected in taxes for this specific purpose, and the more uneven the initial income distribution, the greater would be the improvement in the distribution of income" (p. 211), but as pointed out by Robert Carling (2018), the reader, suspicious of the substantial increase of the tax burden for funding universal

basic income, would like to get at least an illustrative example<sup>2</sup>. The other issue is the political economy of the transition from the incumbent fiscal system, with numerous effectively redistribution programs built into government provision of services (e.g. healthcare and education), to this one, since substantial vested interests should be negotiated.

Thought provoking is the discussion of the constitutional arrangements, again a bit scattered throughout the book. Do constitutions that were formulated in a different period, with social and technological environment rather different from contemporary conditions, serve their purpose? Of course, the target of this question is the US Constitution, with its protection of property rights. What should be the mechanism for revision of the constitutions and how persistent should constitutions be? The book contains many such questions which remain unanswered, without providing even guidelines for finding the answers. However, it does provide an interesting story about the Italian Constitution, which does not protect property rights so strictly, and especially the story about its Article 81, which is intended to prevent reliance on deficit financing of public spending by the Italian Government. The Italian Constitutional Court simply “classified the money obtained from the sale of public bonds as ‘revenue’ available to finance spending” (p. 269). The story provides an explanation of the legal provisions of the huge Italian sovereign debt (133 percent of the GDP in 2017), with the caveat that constitutional restrictions are not effective if there is no independence of those who enforce them.

Part III of the book, “Focusing on Equity”, starts by repeating (again) many insights about the inequality of income distribution that have already been mentioned several times in the first two parts of the book, especially in Part II. Nonetheless, there is a new element – luck. “In the modern world, luck in its various aspects is playing an increasingly important role in generating large incomes for some individuals ... the importance of luck has increased in modern economies because of the existence of modern technologies and government rules, that allow individuals to capitalize on it” (p. 232). Accordingly, Tanzi makes the case that many of the high incomes should be taxed away, because it is, according to the author, difficult to argue “that they should not be reduced by government taxes and by other policies, because they are *fully earned and deserved*” (p. 330, italics in the original). Well, as a comparison, according to Hassan Malik (2018), Bolshevik authorities issued a decree effective from 1 December 1917 (OS) declaring that the authorities have “the right to annul in entirety saving not gained by toil” (p. 222). The only problem with these two approaches, 100 years apart, whatever the differences between them may be, is that there is no answer to several basic questions: who decides whether something is deserved, by toil or otherwise, in what procedure, and what incentives will that create for economic agents.

So, there are two walking models of such luck: “Novac (*sic*) Đoković, of Serbia, and Maria Sharapova, of Russia” (p. 351)<sup>3</sup>. The money they earn is unearned – it is

<sup>2</sup> Harold James (2018) points out that Tanzi has a reputation of someone who is worried about the government being too big and that tax burden is too heavy. That reputation is confirmed in some section of the book. Nonetheless, it is strange that a recommendation for universal basic income is not linked to the corresponding tax burden.

<sup>3</sup> In a funny twist of irony, wrong spelling of Đoković’s name “Novac” means “money” in Serbian. So it is about Novak earning “novac”.



due to globalised sports activities and television coverage, and it is due legally protected rights of companies to have exclusive rights to show the star's name. In short, according to the Tanzi: "Increase in income did not require any extra effort on Đoković's or Sharapova's part. A labor theory of income would not explain the earnings" (pp. 352-253). Although the author does not clarify who in the academic community cares about labour theory of value/income these days, he has an explanation: a luck theory of income. "The *birth lottery* had not played a role except to provide them with talent, but the *time lottery* had worked very much in their favor, by making them be born at the time when their performance could attract more viewers and more value and could be protected by property rights" (p. 353). Exactly, Novak Đoković was even luckier not to be born in Serbia at the time of Ottoman occupation because life there at that time was "solitary, poor, nasty, brutish, and short".

Tanzi accuses even the academic community for increasing inequality: "Some highly visible academics have been reported to have published papers that promoted points of view that were particularly favorable to the groups that had sponsored and financed their research" (p. 337). Well, even an editor of an entry-level daily newspaper would send back such a text to novice journalist, asking him to provide answers to some basic question: which academics, who reported, which papers, in what way favourable, which groups, what was the amount of money in question? Well, the editor of this book, published by a top-level international publisher, obviously did not ask the author, a seasoned and respected academic economist, to provide these answers. Nonetheless, the seasoned and respected economist continues, based on his conjecture, without answering those simple questions. "So, there is here a kind of intellectual prostitution at work. The brains rather than the bodies are hired for performing some services and for providing and generating specific results" (p. 337). What would be a fair word to describe such unsubstantiated accusations remains an open question.

Nonetheless, perhaps the biggest problem of this section of the book is that the reader cannot comprehend the notion why inequality is bad, both economically and politically. Although there are contemporary contributions about that and although the results of them are not unambiguous, Tanzi refers to only one sentence by Kaushik Basu, the former chief economist of the World Bank: "Extreme inequality is ultimately an assault on democracy" (p. 399). That's it! Nothing more.

As to the conclusion of the book, Tanzi refers to Keynes 1925 notion of new wisdom and points out that taking into account things in the world as they are right now, especially in the area of inequality: "We definitely need to 'invent new wisdom for a new age'" (p. 400). The reader wonders what is the wisdom. The last paragraph of the book made it clear. "Wise experts, from different disciplines, should focus on generating that wisdom. A better future depends on their ability to generate the new wisdom that Keynes had called for" (p. 400). In short, final message from the author himself is that there is no wisdom in this book, but only a "do something" appeal.

Not only for the conclusion, or rather the lack thereof, the reader is rather disappointed with the book, especially taking into account the high expectations at the beginning. There are endless descriptions without a proper analysis of very important developments. There are endless and vague descriptions of different views, without the author stating on which side he stands. In many episodes in the book the reader just does not know whether to agree with the author or not because the position of the

author is unclear. In the cases when the position is clear, for example in the case of intellectual property rights, which were under broadside fired, the depth of the accompanying analysis is so shallow, that the reader must do the job for himself/herself. There are a few flashes of excellence of Vito Tanzi in the book. Alas, too few.

Furthermore, the book is difficult reading, because it is not well edited. Many insights are not only repeated but reduplicated throughout the book, across chapters and parts. For example, notion of “too big to fail” is considered no less than nine times in the book, in different chapters and parts, in the exact same way: a description without analysis of, say, economy of scale, prospects of breaking-up big undertakings, with countervailing effects, and *ex ante* regulation of systemically important financial institutions. Obviously, there is no coherent structure in the book. “We shall return to some of these issues in later chapters of this book” is a sentence that is perhaps repeated too often in the book. In short: a reader’s nightmare.

This book is an aberration from Vito Tanzi’s voluminous, valuable and inspirational opus. A substantial one.

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