



Towards a New Economic Theory of the State

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Abstract

The present article traces the authors' approach to constructing a new economic theory of the modern state, considering the theory of patronized goods and a general concept of mixed economy failures as its two important components. This approach is based on the original interpretation of the term 'irrationality' and proposes a more general definition of 'paternalism', revealing negative consequences of its present interpretation. Along with the other failures of the mixed economy, the authors describe a special case—'paternalist failure'—that may be considered a combination of failures in social choice and irrational government bureaucrats' activities. There are five types of bureaucratic irrationalities: Vyazemsky's law, dilettantism, 'cashier effect', Parkinson's law and government officers' 'rent seeking' behavior, that lead to their failure. The authors show that in contrast to market failures impacting government activities, paternalist failures require other responses demanding different activities,—democratic procedures for creating paternalist lines and the introduction of the procedures limiting bureaucratic tyranny.

1. Introduction

Considering a model of the modern state, let us examine the links between the theory of patronized goods and the concept of mixed economy failures (Rubinstein, 2017), summarizing social and merit goods, including the idea of libertarian and asymmetric paternalism. These are the theoretical constructions considering the paternalist activities of a government. Let us recall the definition of the term 'patronized goods'. These are the goods and services, consumption of which the government regulates—increase or decrease—using its choice or preference. At this point we find the connections between the theory of patronized goods and merit goods, libertarian and asymmetric paternalism. But besides the general, we can find specific features.

Considering people's current behavior, we think their activities are subjectively rational in any circumstance, including the situations described by Musgrave, and later outlined by behavioral economists.

But if we label their behavior as irrational, we should not create special constructions with several utility functions for each individual to explain their behavior (Margolis, 1982; Sunstein, Thaler, 2003). Such a construction, as it is well known, includes a weakly

approved assumption that a government knows the individual's 'genuine preferences'. The theory of patronized goods rejects on principle this shabby provision being fairly criticized (Kapelushnikov, 2013, p. 40).

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Its basic feature does not deny a phenomenon of dual preferences, but gives another understanding of its nature. The question is about the presence of the two points for the estimate—each having its own preferences. Based on this assumption, the theory of patronized goods proposes a different understanding of the dual preferences phenomenon.

The basic idea of the theory of patronized goods is to treat individual behavior from “the subjective point of view—as a goal to which an active person aims because he considers it rational.” (Mises, 2005, p. 24) The theory of patronized goods assumes the presence of an independent source of estimate—that is namely the carrier of normative standard. From the point of view of this ‘outside observer’, individual behavior may be estimated as irrational or limitedly rational.

As a matter of fact, we can observe the same situation in macroeconomics, where, as the new Keynesians consider, the economic agents act subjectively, trying to optimize an individual's behavior in time. Moreover, when compared to meritocracies and behavioral economics, government paternalism is based on some individual “genuine preferences”. Economic regulation in macroeconomics is based on the idea of accelerating returns to make full use of resources possible or to reduce balanced economy biases.

Considering all this, “pater” stimulates the changes in economic agents' behavior. One can easily see that a government understanding how to correct its behavior has the same nature as its “knowledge” of individual “genuine preferences”. In both cases, government pater manipulates the behavior of economic agents.

In other words, paternalism in any form means imposing the “pater” settings on members of a specific community of individuals—it may be a household, a company, a social group, whose behavior and/or institutional media (where one acts) is considered ineffective. Concerning this, the nature of paternalism is tightly connected with and even conditioned by the failures of the mixed economy—namely the periodic disproportions between the real results and the normative idea of individual well-being and society's integrity.

2. Social Interest and Paternalist Failures

One of the basic features of the economic theory in progress is the assumption of the concept of economic socio-dynamics and the theory of patronized goods concerning the

interest of society—if any,—which cannot be reduced to the interests of the economic agents (*Grinberg, Rubinstein, 2005, 2013; Rubinstein, 2013*). This important methodological statement contradicts the basic neoclassical statement—methodological individualism.

At the same time, a more detailed analysis of this contradiction allows us to identify a conditional character of this assumption. The point is that a reduction in social interest to the interests of individuals is based on an important latent assumption. By default, we find here a hypothesis of *the perfect institutional environment*—analogous to A. Smith’s ‘invisible hand’—an environment filled with rational individuals. In this case the interests of individuals cooperating with other actors and perfect institutions reach harmony and transform into an integral social interest.

The situation changes radically if we cannot confirm this hypothesis. In these circumstances it is no longer possible to insist that self-interests of acting individuals are transformed into the summarized interest of a society’s integrity. As a matter of fact, these very circumstances led to the introduction of the term “unreducible social interest.” (*Grinberg, Rubinstein, 2005*)

We need to stress that in the real world there are no perfect institutional conditions, where self-regulating mechanisms would work without mistakes, continuously harmonizing the interests of social and economic agents. That is why we can discuss the other nature of social interests and consider a ‘government playmaker’ as an autonomous market actor, using his resources for achieving the goals he declares on behalf of society.

In this context we can think of the two versions of social interest. In one case there is a market coordination of individual behavior, in which their aggregate interest is shaped, and in the other case—there is an autonomous social interest that would not be reduced to individual preferences. We shall think of two parallel processes, about the two lines of creating social interests. At the same time the theory of patronized goods analyzes two lines—the market (economic) and political. Within the political line normative interests and corresponding settings are generated by political institutions which define the nature and substance of government paternalism (*Rubinstein, 2013, p. 18-19*).

Considering the political line and the government with its normative interest, one should not forget about the Boudon verdict. R. Boudon stressed that these assumptions are valid only if an individual is able to act in an institutional environment, allowing him to make collective decisions (*Boudon, 1979*). An institutional system allowing an individual to make decisions on behalf of society is an obvious condition for government designing normative settings.

Collective decisions made on behalf of the government generated by the political line should be considered as the result of a discourse determined by the current institutions and the elite’s interests, capable of both bringing closer real social needs and diverging from it (*Tikhonova, 2013, p. 41–43; Urnov, 2014, p. 26*). “The political process has its own logic; in many cases it does not match with the common logic of optimizing economic mechanisms.” (*Radigin, Entov, 2012, p. 26*),—This is valid and true.

In the recent past, the concept of the “charity state” dominated, which was driven exclusively by the realization of social interests. But in the second half of the twentieth century, a new

logo was playing a more important role—the thesis of shifting the political decisions towards the interests of the ruling elite (*Stigler, 1971*). In the same context one should consider that government paternalism is not always directed to the “pater care” of the people’s well-being according to the initial interpretation of this idea—even in the origin (*Alson, 2006*). In other words, the political line actualizes the interests approved only by the elite.

“The democratization of collective decisions, and search for institutional mechanisms limiting power of the majority, are key tasks for modern political science and the theory of social choice.”

Their assumptions merely become the normative social interests as a result of corresponding collective decisions. Whatever the mechanisms of creating the social interest—whether these are personal decisions of a group leader, or based on the collective’s votes, or a coalition decision—the interest is always determined in the form of pater assumption “as it should be”. For all this the decisions made depend on the level of the society’s development, its political system, the government rules and regulations. That is why the decisions suffer defects, namely—wrong public choice, bureaucratic tyranny, risk of losing social well-being (*Melnik, 2015, p. 16; Gorodetsky, 2016, p. 430*).

It is worthwhile stressing that a parliamentary party (in coalition), formulating the normative assumptions (within the political line), possessing the necessary majority of votes, has the ability to vote practically for any decision in favor of the party interests (*Polterovich, Popov, 2007; Hillman, 2009*). And the point is not whether the parliament is representative and how its work is organized. The principal components are the procedure of making decisions and its basic constituents (*Melnik, 2015, p. 18*).

Related to this, one can formulate the fundamental contradiction of the modern political process. On the one hand, any democratic system is built on the majority’s domination, on the other hand—subordination to the majority would turn into “following the majority”*.

“Many of those, who support democratic “institutions”,—wrote L. von Mises—”would ignore these ideas... The arguments they propose in support for freedom and democracy, are infected with the collectivist mistakes. Their doctrines are likely misinterpretations, than a support to genuine liberalism. In their opinion the majority is always right only because it is able to crash any opposition. The majority is a dictator power of the most member-intensive party. Such a liberalism—namely pseudo-liberalism—is an opposition to liberal doctrine.” (*Mises, 2005, p. 144*) The democratization of collective decisions, and search for institutional mechanisms limiting power of the majority, are key tasks for modern political science and the theory of social choice.

* It is not difficult to resist against the influence of one villain, but many of them are rushing down the slope headlong; not jumping into the stream is the sign of a noble soul and wise mind, educated by courage (cit. from (*Kovelman, 1996, p. 65*)). These modern sounding words, so elegantly formulated, belong to Philo Alexandrinus—a philosopher in IBC, who in his writings combined the Jewish tradition with the Greek culture.

From the end of the twentieth century this theme became popular among researchers. Among them was J. J. Laffont; he stressed that “despite a domineering view of social interests—as a decisive goal in choosing the way for economic development,—intervention of the theory of interest groups, making a special accent on its influence on political decisions, is still expanding.” (*Laffont, 2007, p. 23*) Analyzing this tendency, he points to an ‘authentic adviser’ in the ruling party, who proposes a program of activities aimed at increasing his advantages in a particular economic and political situation. (*Laffont, 2007, p. 22*)

At the same time, it would be a mistake to think of the unique possible choice; it is always in the field of normative decisions where the target guidelines of the parliamentary majority are playing the main role. At the same time, society (according to Laffont) comes into a collision with political tyranny in determining pater assumptions that are fraught with false decisions.

If a problem of “pater” pattern setting is held back or by default is set to increase social well-being in the concepts of public goods, merit goods and new paternalism, as well as in the Keynesian doctrine, then in the theory of the mixed economy failures this question is of prime importance and it is thoroughly examined through the optics of collective decisions taken by the parliament. The parliament by itself may be considered as adviser to political parties, representing the interests of relative groups of voters.

Such an approach is the basis for using Arrow’s theorem “on the impossibility” of the integrity of authentic advisers. It makes the following conclusion: it is impossible to coordinate the parliamentary parties’ interests. It is necessary to notice that the real political practice of the democratic governments demonstrates the general rule: every parliament would evolve towards a collective dictator (according to Mises) in the form of a party-in-power or the parties’ coalition, which, as a rule, possesses the necessary majority of votes for making decisions.

Moreover, parliamentary voting would produce “paternalist” assumptions not related to the needs and priorities of a society, ignoring the preferences of small parties, and the interests of their many million voters. This outcome may be applied to any procedures of collective decisions, about which Boudon wrote and against which Mises warned, creating distrust in paternalism and government activities in a majority of economists and politicians.*

In these circumstances a doctrine of charity-state is obviously not correct. Let us examine the fact that the consequences of assumption not corresponding with the needs of society may be the decline in well-being, explaining one of the mixed economy failures—“*paternalist failure*”.

It is necessary to stress that paternalism in any government system would lead to a strong government, which would, as a rule, drift to a “Leviathan” system. At the same time the negative consequences of government paternalism may strengthen because of improper

* Let us mention the writings of the representatives of the Virginia school of political economy C. Rowley and M. Vachris; they showed up as the opponents to “free electors’ choice” (*Rowley, Vachris, 1993, 2004; Rowley, 1997*).

bureaucrats' activities, at the same time generating "government failures", provoking the very special type of paternalist failure—"bureaucrats' failure."[†]

3. Bureaucrats' Failure

According to the well-known principles of behavioral economy and alongside Max Weber's traditions (*Weber, 1994, p. 57-58, 345*), we shall further understand "bureaucrats' failure" as the *irrational activities of bureaucrats*. Let us analyze the behavior of government officers[‡] whose activities do not always correspond with the assumptions of the government's strict orientation to the implementation of representative and executive power—that is one of the key problems of the general theory of the mixed economy failures.

3.1. Irrationality of Bureaucracy

At the same time there are no ideal conditions for bureaucrats—each in his place—to act without mistakes. The standard theory does not give enough explanations for this phenomenon, but gives reasons for analyzing the behavioral peculiarities of bureaucracy. The examination of different government service concepts (*Obolonsky, 2000; Vassilenko, 2001*) provides the ground for affirmation, that one would find here the methodological assumptions, based on rational behavior principle this time—specially for bureaucrats.

According to this principle, every government officer would choose the best variant for his activities optimizing not only his own well-being, but the society's as well. In other words, any bureaucrat would seek maximizing his utility function within the given limits, making up his position functions. All the rest would be provided by the institutional system of the government rule, aimed at harmonizing social interests with government officers, thus closing the gap between executive power decisions and the government's assumptions, formed within the frames of a political system.

If government rules and regulations fail and generate the wrong decisions causing losses in social well-being, these failures are explained by governmental dysfunctions—the failures of the system itself that need to be reformed—and/or irrational individual activities of the government officers. Not diving too deep into this subject, we stress the most important point: an effective system of government administration is driven by the *rational* behavior of bureaucrats. At the same time their activities are rational only when they are able to choose those lines that would mostly respond to their preferences— within the available variants.

At the same time, recalling Blaug, let us note that even in the activities of government bureaucrats, "it is impossible to exclude the behavior driven by immediate impulse, a habit... or even by the forgetfulness" (*Blaug, 2004, p. 351*) that allows proposing the possibility of choosing not the best variant, thereby leading to a loss in social well-being. Let us add that—

* The government dysfunctions may mean excessive government interference, as well as a lack of its necessary activity (*Crosier, 1997, p. 699*).

† We can find descriptions of similar government failures, as contrasted with market failures, in a number of publications. For example, in (*Krueger, 1990; Tullock et al., 2002; Winston, 2006; Radygin, Entov, 2012*).

‡ Officer here is an executive manager within a system of public administration.

as in the case of economic agents' "behavior failure" (*Gorodetsky, Rubinstein, 2017*)—there is a lot of evidence revealing the failure of rationality principle in bureaucrats' behavior (*Zinchenko, 2002*).

If economic theory, which allows government interference in individual behavior, explains it by individual irrational activities and pater's drive to push economic agents to choose some "genuine preferences",—we shall observe a completely different situation about irrational government bureaucrats' behavior. "Genuine preferences" in this case is not a hypothesis. On the contrary: every government officer—according to his professional functions—is assigned what to do in order to implement government decisions. So here comes the question: why and how are bureaucrats' irrational activities generated?—the activities leading to "bureaucrats' failure."

The analysis of different concepts and practices of the government gives us a possibility to forward a hypothesis about the several types of irrationality of government officers, stipulated by *objective imbalanced interests* of the government. These bureaucrats are also called to implement their personal interests as individuals. This imbalance, to our mind, reveals the negative aspects of the government administration system, leading to government failures, breaking economic growth and creating losses in social well-being. Let us discuss this hypothesis, having distinguished a number of institutional reasons for irrational bureaucrats' behavior without giving a full description of the nature and types of "bureaucrats' failures."

3.2. Vyazemsky's Law

Let us ignore the rational behavior of bureaucracy and look at another fact—in many cases rational behavior is driven by the institutional environment: specific acts, current norms and regulations. At the same time many analytics note the "genuine character" of any bureaucratic system—that is an excessive number of various instructions at different levels of executive power, often impossible to be implemented (*Dolfsma, 2013*).

Let us point at inflexible legal and normative acts concerning economic activities, the undue tendency of a government (as certain administrations) to unify its establishing norms without considering different specifications of various branches and forms of (economic and social) activity.

Let us analyze the example of the Russian Federal Act on the contract system concerning provisions, works and services for the government and municipal needs. This Federal Act sustaining competition (between service companies) requires open tenders in every sphere—in providing resources for the offices, and for inviting the famous tenor for opera performance in the Bolshoi Theater.

Last year's procedure for such unification followed practically all the government acts, regulating the activities of legal bodies in Russia without any concern for a particular branch or sphere. And as it usually happens, nobody is trying to respect the given norms. It looks like this has become a common practice and a special feature of the Russian system of management.

Let us recall the known motto of Peter Andreevich Vyazemsky: “severe Russian laws are moderated by the failure to their implementation.” This institutional feature provokes bureaucrats’ irrational behavior, with its inevitable consequences—bureaucrats’ failures.

3.3. Dilettantism and a Capture of “the others” Competences

Let us observe some specific circumstances that illustrate the irrationality of bureaucracy. First of all—and like the famous Lester Salamon analysis (*Salamon, 1987*)—it is necessary to point to the dilettantism of the clerks. The thing is that people without necessary professional competences, knowledge and skills are appointed to managerial positions at different levels in modern government—from their affiliation to the particular political elite (*political principle*). Let us also add nepotism (*clan principle*). Nominations to high positions in executive institutions also give way to the practice of “one’s own” people (*clan (or nepotism) principle*).

No doubt, we cannot exclude the situations when these methods would still provide nominating professionals with the necessary characteristics. But in case a dilettante becomes the boss, our hypothesis would be considered funded. Thus, “bureaucrats’ failure” becomes inevitable. The incompetent officer is unable to exercise his duties. Making mistakes in making important decisions, he would in fact substitute rational behavior—by acting “from general assumptions.

Let us distinguish another type of irrational bureaucrats’ behavior, which reaffirms our hypothesis. Let us turn to the irrational behavior of government officers, who are willing to extend the frontiers of their influence and rule beyond the frames of their competences. This phenomenon, called “cashier syndrome,”* is well known and is widely discussed in the literature (*Zverev, 1992, p. 91; Chesnokov, 2000, p. 161-171*). This syndrome is seen in individual officers and at the administration level.

The same situation can be traced in the takeover of outside competences by the Finance ministry. The concentration of the most economic management functions in this Ministry has narrowed its ability to influence economic development of the country by the due Ministry of economic development. Concerning the basic function of the Finance ministry—to rule and regulate the budget policy—its jump beyond the functions would increase the risks of irrelevant strategic decisions running contrary to the task of economic growth.

Another example of a takeover of “others” (outside) competencies is the activities of the Federal Agency for Scientific Organizations (FASO, Russia) that go far beyond the material provision of scientific organizations. This situation requires a more detailed analysis, but it looks like this Agency with a thousand manpower managerial staff, was able to grab “the second key” to the Russian Academy of Sciences. This situation has dramatically reduced the ability of the Russian Academy of Sciences to influence the process of scientific research and development in the country.

* One usually thinks that nobody wants to be “just a cashier”—everyone who is handing out cash would like to decide by himself, whom to, what for and how much money they would like to hand out.

Apparently, a more frequently observed situation of an outcome beyond one's competences can be observed at the individual level. "Bureaucratic tyranny" has been analyzed in many publications (*Smirnov, 2009; Obolonsky, 2011*). We stress again that in many cases this tyranny is caused by the attempts of an individual bureaucrat (administrator) to extend personal power.

In all similar cases, such a "privatization of authorities" limits the legitimate opportunities of other citizens, thereby increasing the risks of failure to execute the tasks settled by the government. The bureaucrats' tendency to broaden their authorities comes out in another situation that may be attributed to the third type of irrational behavior.

3.4. Parkinson's Law and Self-interest of the Bureaucrats

We should deal here with the opposite trend—a transfer of some competences to a lower, but a reporting-up level; and artificial complication of management structures. Cyril Parkinson gave support to the truth of this hypothesis saying: "a bureaucrat multiplies his subordinates, meaning he would shift his responsibilities onto their shoulders." (*Parkinson, 1957*).

According to Parkinson's law, the number of bureaucrats is increasing. Parkinson proposed a formula: $X = (2S^m + L) / N$, where S is the number of office workers hiring subordinates, L —the number of years in work; m —the number of hours spent processing the material, N —the number of necessary office workers; X —the number of new office workers hired in one year (*Parkinson, 1957*).

Despite the constant call to decrease management staff, the Russian administrative reforms did not stop uncontrolled growth of the number of government officers and bureaucratic burden on the economy. When we increase the authorities' power and promotion, a bureaucrat increases dilettantism and a number of ineffective management decisions. These circumstances decrease their ability to react flexibly to the new challenges and solve economic development problems (*Vassilenko, 2001*).

Bureaucrats' drive to concentrate power authorities and approach a budget pie would lead to the illegitimate capture of the "outside" (others') functions unusual for specific institutions and organs. The penetration of executive power into practice and authorities of local administration runs along the same lines.

The three investigated types of irrational behavior could be most frequently found in a situation with the fourth factor of bureaucrats' irrational behavior—their motive to increase personal well-being in all possible forms. At the same time, a balanced government system providing managers' interests (in case of perfect professional functioning) as well as management activities would increase the well-being of the bureaucrats (officers) and the society.

The circumstances of real life differ from theoretical constructions; a bureaucrat's personal interest does not meet the demands of government service and his job descriptions. History

and modern practice have not witnessed many situations where the systems of government regulation, economic stimulation measures and ethnic norms, fixed in the corresponding normative acts, based on specific and general legislation, would provide balance of interests. On the contrary, and in most cases, the analytics reveal self-interest and rent-seeking behavior of the bureaucrats, meaning the desire to profit from their position (*Krueger, 1990; Tullock et al., 2002; Winston, 2006*), which generates high corruption potential.

3.5. About the System of Government Administration

The discussed types of irrationality of bureaucracy do not reveal all the reasons for “bureaucrats’ failure.” Further investigation is necessary here; its results would give us an integrated picture of the behavior of this group of individuals that fundamentally differs from the behavior of economic agents by contents and aims of their activities—the latter are fixed by “the other people”—that shape up their job responsibilities. Here we always find a conflict between personal interests of the bureaucrats and the interests of society.

It is necessary to note that the temperature of a conflict depends not only on the design of the system of government administration, but on the civil culture of a certain society at a certain stage of development. Modern research reveals the links between institutions, economic decisions and culture (*Putnam, 1993; Alesina, Giuliano, 2016*). So it is necessary to learn the factors directly influencing bureaucrats’ behavior. Measured characteristics—such as “general trust”, “general morality” and “job behavior” (*Alesina, Giuliano, 2016, p. 91-93, 97-99*)—would determine the honesty, responsibility and faith of the bureaucrats, which influence their rational behavior.

K. Arrow puts it like this: “One can surely assert that a considerable portion of economic backwardness in the world may be explained by the lack of mutual trust” (*Arrow, 1972, p. 35*). Similar investigations should become, to our mind, a part of institutional modernization, and first and foremost of the administrative reform directed at the creation of a government system of administration, providing lower risks of “bureaucrats’ failure”. “Paternalist failures” alongside the institutional, distribution and behavioral failures would allow us to analyze them from the common grounds—namely as special cases within the general theory of mixed economy failures where the government acts as the pater (*Gorodetsky, Rubinstein, 2017, p. 32*). Paternalist failure clearly shows that government activities are accompanied by the risks of making wrong decisions enforced by undue practices.

It is necessary to pay special attention to the fact that “pater” itself is not able to eliminate the failure of the pater-government, compared to the standard mixed economy failures that would be removed by the government activities. It is odd to believe that Munchausen would draw himself from the swamp by his hair. And only the third participant of economic relations—a civil society (civil activity and self-organization if the citizens)—is able to create an institutional environment, capable of lowering the risks of wrong decisions, and providing social control within the system of government administration (table 1).

Table 1. Mixed Economy Failures

Mixed Economy Failures	Government Activities	
Institutional Failure	Pareto-ineffective balance (monopoly, externalities, information asymmetry etc.)	Paternalist activities of the government aimed at changing the institutional environment respecting freedom of consumer choice
Distribution Failure	Pareto-effective balance with unacceptable wealth distribution	Paternalist activities of the government aimed at changing the budget limitations of individuals (redistribution) respecting freedom of consumer choice
Behavior Failure	Individual irrational behavior	Paternalist activities of the government aimed at changing the consumer choice
Paternalist Failure	Failures of social choice Irrational bureaucrats' behavior	Civil activities aimed at democratization of social choice and lowering the risks of irrational bureaucrats' behavior

Thus, if the standard market failures—institutional, distributional and behavioral—influence government activities, the paternalist failure becomes the immediate consequence of this activity, and demands different actions—the actions directed at demonopolization of creating normative assumptions, introduction of procedures limiting the bureaucratic tyranny, lowering the risk of “bureaucrats’ failures” and associated losses in well-being.

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