

# Welfare Economics and the Welfare State

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*This paper discusses the role of the economist in making normative statements about the welfare state. The familiar difficulties of interpersonal comparisons and value judgement are examined. It is argued that the economist's role, though limited, is an important one not only in discussing the general economic implications of welfare expenditures but in analysing the scope that is permitted for the expression of individual preferences.*

## I

It would be only natural if those unfamiliar with economic literature were to suppose that there is an intimate association between "welfare economics" and "the welfare state". For such an association might be suggested by the repetition of the word "welfare", first in a technical and then in a colloquial sense. Indeed the welfare state might even be regarded as an institutional application of welfare theory! Some surprise might then be occasioned by their being told that this is by no means the case and that the links between welfare theory and the welfare services have been unsystematic and weak. Of course it is true that economists have not only embarked upon empirical investigations of the welfare state but have attempted to reach normative conclusions. The fact remains that the public provision of benefits, in cash and in kind, has been regarded by economists rather as a topic for specialised study that lies on the periphery of professional interest and has not been subjected to rigorous economic analysis as fully or as frequently as its quantitative importance would appear to warrant. At all events, this has been the position in Britain.

The explanation must be sought partly in the limited scope of welfare economics as it has evolved in modern times. "The welfare state" may be broadly defined as a group of official policies designed to provide certain categories of people with incomes, in cash and kind, in excess of the *current* contributions to production. Thus the study of the welfare state – unless so conducted as to be strictly empirical without normative conclusions – would seem to confront economists with precisely those problems of interpersonal comparisons of utility and of value judgements which

Paretian welfare economics has been designed to avoid. When cardinal utility was thought to be a respectable concept and its maximisation in a community was regarded as an objective that no-one could reasonably question, economists were prepared to commit themselves to recommendations about tax policies that were based on the distributional effects these policies could be expected to have. Admittedly not so much was said about expenditure – not, at least, in the Anglo-Saxon literature. But benefits to identifiable individuals – that is to say, benefits other than those derived from pure public goods – can be regarded as taxes with a change of algebraic sign. The earlier cardinalist literature could therefore be said to cover modern welfare benefits as well as taxes. When, however, this whole theoretical structure was blasted and flattened by the positivist wind that blew so strongly for so long a period, it became difficult to maintain that economists could make relevant recommendations without going beyond what appeared to be their legitimate domain. With interpersonal comparisons of utility ruled out and with moral value judgement avoided, the welfare analysis still deemed to be permissible had, naturally, much less to say that was relevant to the assessment of welfare policies of a redistributive nature. It is true that the restrictions thus imposed have not affected in the same way all the different aspects of policy with which economists are concerned. Thus the recommendations made about macro-economic policy do not seem to be much inhibited by the fact that interpersonal comparisons of utility and ethical value judgements are often embodied in them. For, though present, these difficult matters are decently concealed. It is a different matter when

distribution is a central issue, as in the case of the welfare state.

It is scarcely necessary to add that the difficulty of handling distributional issues is, indeed, so great that economic analysis can yield only provisional and qualified recommendations. Interpersonal comparisons of utility can, of course, be made; the difficulty is to apply some objective test and to achieve agreement. The basic value judgements embodied in distributional recommendations may also be conflicting. A conflict of basic value judgements may be said to occur when different recommendations would be made by different people even if they were in complete agreement about the facts of the situation. Of course it is the case that such difficulties limit the scope of welfare economics. The question that remains is whether these obstacles are so central and so immovable as to justify the extent to which the welfare services in general, and cash benefits in particular, have been neglected in welfare economics.

First, it may be asked whether the Paretian analysis itself, when amended to allow for interdependent utility functions, may be so extended as to permit relevant recommendations to be made. Secondly, it may be suggested that economists should be prepared to break out of the Paretian confines altogether, to commit themselves more boldly to expressions of opinion about justice or even to claim that cardinal utility is, after all, a meaningful and a useful concept.

Whether or not such explorations prove to be successful, it remains true that there is scope for the fuller and more persistent application of the economist's more traditional skills. After all, the basic questions about the allocation of resources need to be asked in this context as in others. How is the allocation to the welfare services as a whole determined? What determines the allocation between different parts of the total welfare budget? Is the use of resources reasonably efficient, given the preference patterns? Are people in a position to express rational preferences between different alternatives? What is the justification for the compulsion that underlies all these schemes and for the uniformity of provision which they often impose? And so on. There is no need to add to the list at this stage. Nor is there any need to say that such far-reaching questions cannot be satisfactorily pursued within the scope of a single paper. It must suffice to develop some of the more general points a little further in the next part, in the following one to provide some illustrations,

and then, finally, to put forward some conclusions.

## II

Analytical welfare economics is firmly individualistic. It is so, first of all, in the anti-metaphysical sense that social welfare is identified with the welfare of the individuals who comprise society, not with that of some mystical entity such as the Nation, the People or the Proletariat. Individualism carried only to this extent would impose no obstacle to the analysis of the welfare state; but it may be pushed much further. Thus, in the standard version of Paretian welfare economics, utility functions are independent so that each person "exists in an isolated cell connected with the rest of the world only through the exchange of goods and services." See Vickery (1973, p 37). At first glance this would not appear to provide a promising basis for the study of the welfare state, but it is necessary to reflect upon the reasons why an assumption of "isolated cells", may be made. First of all, it should be noted that the reference to the exchange of goods and services is crucial. With an elaborate division of labour, everyone has a particular area of responsibility as producer or consumer which must be his or her own particular concern. Special circumstances apart, you are under no obligation to accept a bad bargain from me as though you were assuming my responsibilities as well as your own. On the contrary, you should try to get as good a bargain as you can and you can feel that, in doing so, you will usually be enhancing social welfare. For this is how information about preferences and costs is conveyed; this is how efficiency is rewarded and inefficiency penalised. (We may note in passing that much the same can be said about the Socialist economies as well as the Western ones.) In short we must distinguish between *non-tuism*, C. C. Wickstead (1833) called it, and selfishness. One may be behaving in a *non-tuistic* way but one's objectives may be selfish or altruistic or a combination of both. See MacKean (1975) and Wilson (1976). It was entirely proper to base welfare economics on the assumption of independent utility functions in the sense of *non-tuism* in so far as this welfare analysis was concerned with production and exchange. Public finance, including the welfare services, raises other issues.

Secondly, the assumption that people occupy isolated cells may be based on the quite different Hobbesian assumption of egoism over the whole

range of personal activity. This is a much stronger assumption but is by no means inherently inconsistent with support for any form of welfare state. In giving such support people might only be resorting to what they regarded as one of the available methods for advancing their self-interest. In doing so they would, it is true, be endorsing the use of compulsion and accepting some measure of uniformity in the provision of services which might conflict with their own preferences; but they might feel that, on balance, the package was worthwhile. It might be so regarded even by those who expected that their income class would be made to pay more than its proportionate share because, as individuals, they would have protection against risks. Those who believed – rightly or wrongly – that other classes would have to meet proportionately more of the cost would have a still stronger egotistical reason for giving their support. Given this starting point in egoism, the economist would have the role of assessing how far the pursuit of self-interest in the case of particular welfare services was really enlightened; for people might, of course, be mistaken about the means they had chosen to advance their objectives.

Although, for the purposes of an exercise of this kind, economists might accept the assumption of completely egotistical behaviour, they would be going beyond their professional competence if they themselves were to assert that such an assumption is a fully realistic statement of human motivation. For it could be objected, whether on the basis of psychological enquiry or simply of ordinary experience, that people do not live in isolated cells, that interpersonal comparisons of utility can be made and are, in fact, made and, therefore, that utility functions are not independent. To recognise that this is so does not preclude acceptance of the Paretian proposition that situation A is better than situation B if individual *i* is better off and no one else is worse off, but "better off" and "worse off" must be taken to refer not only to supplies of goods and services but, in the most comprehensive sense, to all conceivable considerations. The latter must include any feelings of guilt on the part of the more prosperous – the "middle class conscience" – and feelings of resentment on the part of those who believe themselves to be relatively deprived.

Interdependence in utility functions provides an adequate explanation of altruism, a point that was made more elegantly by Adam Smith himself. It has been maintained, however, that interde-

pendence also provides an explanation of compulsory fiscal transfers. See Hochman and Rogers (1969). There are various reasons why compulsion might be introduced. Thus, it might be held that in this way the total sum to be transferred could be better assessed and determined beforehand and the burden more fairly distributed. We could therefore envisage donors expressing their preferences by agreeing voluntarily to a social contract that would provide for compulsory transfers. The practical difficulties would, of course, be immense with voting in the form of referenda on specific issues and with the franchise confined to potential donors. Moreover, if the contract were to be genuinely voluntary so that it could be defended to a Paretian welfare economist as an expression of what were basically unforced preferences, no one should be obliged to give more than he wished to give. An important conclusion follows. It is that even if we were to relax Wicksell's unanimity rule a little, as he himself was prepared to do, it is scarcely conceivable that transfers would take place on the large scale to which we have become accustomed. It should be observed that, in this situation, those who were potential donors would not be making their decisions behind a Rawlsian "veil of ignorance" and might feel, in many cases, that there was not much likelihood that they themselves would have to rely significantly upon the receipt of transfers. Though moved to some extent by sympathy, benevolence or a sense of guilt, they could also be expected to accord heavy weighting to their own self-interest or to the welfare of those who were close dependents.

The method of approach we have just described is in any case open to the objection that it is too conservative in that excessive stress is placed on voluntary modifications of an initial income distribution which may have been a far from satisfactory one. Adam Smith's "Impartial Spectator" would surely have expected more than this! It can be pointed out that this particular distribution is, in principle, only one of many possible distributions. If movement from it is only to be made to the extent that this is sanctioned by those who will voluntarily surrender some goods and services, then the whole welfare system is still only partially ordered. The *optimum optimorum* has not yet been reached. In reply it may be said that one must always start from some historical situation and that, in any case, it is foolish to talk about an *optimum optimorum* which will not be attained and could not even be defined without embarking upon an ethical investigation into so-

cial justice. It does not follow, however, that the initial distribution is in some sense superior to all others.

Some economists, in their impatience with Paretian inhibitions, appear to have been quite prepared to direct their attention to questions of social justice. The interest aroused by Rawls' *Theory of Justice* (1971) was evidence of this dissatisfaction and readiness to consider new approaches. Unfortunately the difficulties have remained. Rawls' views were widely welcomed; they were also widely criticised. This outcome was scarcely surprising. This is not a field of speculation where agreement is likely to be reached. An economist who decides nevertheless to explore this field must be fully explicit about what he is doing and careful not to represent as conclusions of economic science, recommendations that are substantially derived from non-economic considerations.

### III

The welfare state, as defined above, includes a wide range of measures. This range is sometimes limited by convention. For example, the EEC includes cash benefits and health benefits in kind; but educational benefits in cash and kind could also be included and so could housing subsidies in so far as these are not covered by the cash benefits. Rather than attempt to comment on so wide a range of provisions within the compass of a short paper, it may be more illuminating to take an example and the one I shall choose will be the provision of benefits to the elderly which account for much the larger part of cash benefits in nearly all countries.

Why should such assistance be thought to be necessary? Why should people in rich developed countries not be left to make provision for themselves? The number likely to be destitute could be expected to be quite substantially less than the present number of pensioners if people were taxed less and left to look after themselves. But some would be in trouble as a consequence of invalidity or ill-luck in the management of their affairs or simply from improvidence. We can reasonably assert that there would be almost universal support for the view that no elderly person should be left totally destitute partly because utility functions are interdependent and partly because self-interest may lead people to endorse the provision of benefits which, in the unforeseeable future, they might need. It is true that the families of the needy could be expected to come to the rescue as do

the extended families in less developed countries, but family responsibility has been undermined in developed countries – though it is fair to add that this is a consequence as well as a cause of assistance from the state.

The assistance thus deemed to be necessary could be provided only subject to means-test. Total expenditure would then be substantially less than it is under an official pension scheme because assistance would not be provided to those who did not need it – apart from errors in administration. The possibility of relying upon means-tested assistance may seem rather academic in Europe and North America but it should be noted that this has been a real issue in Australia. Does welfare economics help in making a choice? There are the obvious points that means-tests weaken the incentive to help oneself by working and saving. On these points at least the economist should be able to give clear advice of a quantitative nature but, in fact, finds it hard to do so. Empirical matters of this kind which are within our competence in principle are not always so in practice! Then there is a more basic philosophical point. Means-tests may undermine self-respect with the result that some people will be tempted to be free-riders and others will feel a sense of stigma.

Economists must be careful at this point. Welfare economics is still basically utilitarian even although cardinalism has been abandoned and "the greatest welfare of the greatest number" is seen to be not only vague but to embody a value judgement. It should not be forgotten, however, that in assessing any public policy, account can also be taken of its effect on personality, on the sense of duty and the sense of obligation. It is not, of course, the job of the economist to decide what weighting should be given to deontological considerations of this kind but he must be careful not to adopt, implicitly, a particular philosophical position by leaving them out of account.

If it were, indeed, possible to devise a social insurance scheme under which everyone paid for what he got, then the distributional issues which cause so much difficulty in welfare economics would appear, at least at first glance, to be bypassed. This, of course, is what Beveridge (1942) recommended. There should be flat-rate benefits for flat-rate contributions with the need for means-tested assistance – "public charity" – reduced to a small number of difficult cases. It is true that each person's benefits would not correspond precisely to his contributions for this was to be an insurance

scheme. Moreover, it was to be a national scheme which did not allow, as private insurance would do, for the fact that certain categories of people were more subject to risk than others. Some distributional changes would take place but, given all the assumptions of the proposal, their quantitative importance would be limited and also justified if the basis of the scheme were generally accepted. Beveridge, however, was in various ways inconsistent in applying this recommendation that people should pay for what they got. Thus, he proposed that there should be benefits for the dependents of the insured and this implied transfers. In practice, nearly all schemes do, in fact, provide for dependents although the German pension was for some time an exception. This issue has been taken up recently in the USA, notably by Derthick (1979) who maintains that dependents should be excluded from social insurance and provided for by means-tested assistance. Does welfare economics help at this point? Only, perhaps, to the extent of endorsing the general case for the consistent application of concepts. That is to say, if we are talking about social insurance we should not smuggle in something else. But "social insurance" may now be so muddled a concept for quite a number of reasons that it is pointless to try to purify it.

If it is assumed that some national minimum is to be provided, as of right or subject to means-tests, it is still necessary to determine the level at which it should be set. There is no definite scientific way of making an assessment and judgement is always involved. What can be said with some confidence is that the higher the level that is being considered, the greater the likelihood of disagreement. The Hochman-Rogers (1969) approach would no doubt yield nearly unanimous support for protection against the desperate extremities of total destitution; but views will differ more, compulsion will matter more and political weight will become more important when the minimum is far above what would be needed as protection against destitution and provides for at least some conventional luxuries. There is the further question as to how often the basic minimum, once fixed, should be altered. Interdependence in utility standards helps to explain the fact that "poverty" is a relative concept. But how relative? How often should the standard be changed? Should it rise with rising real wages as was the case until recently in Britain – which is one of the reasons why neither growth nor the welfare state has seemed to be successful in abolishing

poverty! The economist can give no definite answers to these questions but he, for this part, can ask some empirical questions. How has the minimum been determined at a particular point in time? By whose authority? With what attempt to test public preferences? With what allowance for wider consequences in the economy? He may also perform the more humble but exceedingly important role of combating the misunderstanding caused by ambiguous statements about "poverty".

Flat-rate benefits are now the exception for pensioners and, in the countries where such benefits still survive – as in Sweden and Britain – there are also supplementary pensions which are graduated. See Wilson (1974). Graduation clearly raises important issues. What is the justification for official arrangements, backed by compulsion, for carrying over into retirement some of the inequality of working life? It is true that this transmission of inequality takes place only within limits, for the benefits normally have maxima and minima and, furthermore, a graduated scheme may be kinked in such a way as to favour the poorer pensioners – as in the USA. But it is still necessary to ask why there should be graduation at all. If one is prepared to adopt a bold utilitarian attitude, the beginnings of an answer can be given. For it can be held that what should concern us is the distribution of welfare, not the means to welfare. That is to say, allowance should be made for the fact that the capacity for enjoyment differs from person to person. For example, Sen (1973, p 87) has argued that an invalid can be expected to derive less utility from a given income than a normal healthy person and should, in fairness, be given more for this reason. When the application of this argument is extended it becomes apparent that it has strong conservative implications, for the satisfaction a person can obtain from a given income will depend partly upon the standard of living to which he has been accustomed. Habit is far wider in its relevance than the special case of invalidity to which Sen refers.

There is, however, no real need for economists to become quite so deeply involved in interpersonal comparisons of utility. Such comparisons can, of course, be made but are hard to check. As has been suggested, there appears to be a sufficient consensus to warrant support for providing some minimum standard, some floor below which no one should fall; but we should be plunged into controversy and baffled by uncertainty about psy-

chological states if we were to attempt to devise a distribution of income that allowed for differences in the capacity to enjoy. Of course, it is to be expected that people with higher incomes at work will want to have higher incomes in retirement, but it is up to them to make provision accordingly. Compulsory contributions for official benefits impose a degree of uniformity in life-cycle provision which is not easily justified in principle.

There is an analogy here with the debate about the case for providing benefits in cash or in kind. Welfare theory would seem to support the former because preferences differ and satisfaction will be greater if this is recognised – the utilitarian point. To do otherwise is to subject people to dubious interpersonal comparisons of utility made by some outside authority on their behalf. Moreover the exercise of freedom of choice may also be preferred on deontological grounds. It is true that a strong case can be made for a more paternalistic and a more egalitarian approach in the case of health services or, at all events, of that part of the health service which is crucial to the preservation of life or the mitigation of serious suffering, but it becomes a lot less plausible in less desperate cases. The extension of this line of reasoning to graduated pensions fails, however, to carry the same conviction.

The benefits provided in some countries to the elderly are now so large as to impose a heavy burden on the working population which is beginning to be resented. This would appear to be the case in Sweden. See Wilson (1979). The aim in some countries is to provide about three-quarters in income from work of the average wage-earner which, when allowance is made for lower costs after retirement and for tax, would permit something like the standard of living of working life to be maintained from state and occupational pensions apart from any dissaving of previous private accumulations. Those with less than average earnings may even be better off in retirement than they were when working and perhaps supporting a family. It is true that we have not moved so far along this path in Britain and it is not planned to do so; but a number of continental countries have gone a long way, or will go a long way when existing schemes are fully mature. Moreover, the elderly make a heavy claim on health services. It is quite reasonable to ask whether those still at work, especially those with children to support, are not being expected to do too much.

It may be objected that the economist, whatever views he may hold as a citizen, has no basis

for appraising this scale of provision for the elderly, either favourably or unfavourably, so long as he confines himself to his own subject. If "society" has chosen such a policy, why should he object? In fact, however, he has still something of importance to say. First, he can point out that large unfunded schemes may have a bad effect on saving with damaging consequences for growth. It does not follow that a return to funding should be recommended for this would not be realistic. No working population can be expected to provide *both* for those who are currently beneficiaries on a pay-as-you-go basis (because there is no fund on which to call) and also to contribute to a fund for their own future. Funding for official schemes is now relevant only when new schemes are introduced. Even if this were not so and all benefits could be funded, the size of the fund required would be enormous and the rate of return on capital would then be low – a fact which, in itself, shows that beneficiaries may often be getting more than they paid for in the sense that the implicit return on their contributions is above the probable market rate that could be expected on a fund. The managers of so large a fund would also be in a position to exercise immense control over industry. Even the funded private schemes convey a great deal of power to the financial institutions which control them. This is now an issue in Britain. Is it really desirable to reduce so drastically the role of the private investor?

Secondly, the economist can ask whether the citizens of a country have been offered a clear and fair choice between the forced saving implied by both public and private schemes on the one hand and voluntary personal saving on the other – above what would be needed for some reasonable minimum. The fact that *employers* make large contributions confuses the issue. For people must often suppose that they are getting benefits at the expense of profits. But the sums involved are so large that the levy, whether for official or private schemes, must be passed on almost entirely as higher prices. Thus, the burden falls on the population at large as an indirect tax of uncertain incidence with no regard to equity. Moreover in so far as profits are sometimes squeezed, investment and output may suffer. Finally, the tax on labour warps the choice between factors. There can be no doubt that the employers' payroll tax is a bad tax and ought, if this were politically possible, to be scrapped. Hypothecated taxes are supposed to convey more clearly the sense that there is a budget constraint but this tax does

not do so and is inferior for this reason, and for the other reasons just mentioned, to finance from general revenue.

The fact remains that it would be foolish for any individual acting in isolation to opt out of these schemes, if the choice were given, unless compensated to the extent of all the payments that would otherwise be made on his behalf including the tax concessions. The only choice ever offered, as far as I am aware, is that between public and private schemes, and this is not enough. It cannot be said, therefore, that the present system reflects preferences freely expressed between fairly presented alternatives. We have spent much time discussing the imperfections of the market, but must not neglect the imperfections of the political process.

There is, of course, another reason why, in most countries, it would be foolish for any individual to opt out of an official pension scheme. This is the fact the such schemes are usually indexed and provide a measure of security against inflation that could not be obtained from holding a financial asset. To test preferences by offering the opportunity to opt out would be a pointless exercise unless some inflation-proofed asset were provided as an alternative.

It may seem somewhat academic and fanciful even to consider the possibility of allowing people to opt out of all but the basic benefits. Yet in practical terms, this could be done subject to the condition that there could be no opting out and in and out again with changes of mind! The other reason for reflecting on this possibility is that, by doing so, one perceives quite clearly how warped the welfare state has become. There has been no question of allowing people to express their preferences as between different fairly balanced and fairly presented alternatives. In traditional welfare economics great stress is placed on the need to respect individual preferences and to bring them into the "right" relationship to costs; but in public provision, preferences receive too little attention. Graduated pensions are, of course, only one example.

#### IV

Assar Lindbeck (1975) has observed that a large part of welfare expenditure in Sweden involves no vertical redistribution. This is also true of other countries, and the time has surely come to consider again the purposes that these vast programmes are meant to serve. Protection against "po-

verty" was once the central objective but it is now only one of several. When account is taken of the whole range of services provided by the welfare state, both in cash and in kind, it becomes obvious enough that large sums are paid over for benefits that the recipients are, in effect, paying for but have not freely chosen. Moreover, the paternalism which has accompanied and partly inspired the empire-building of politicians and bureaucrats can be regarded as unattractive from a deontological as well as a utilitarian point of view.

The stagflation with which the nineteen eighties have begun, together with ominous demographic movements in some countries, has led to growing concern about the current scale and possible expansion of welfare expenditure. In some countries (e.g., in Britain), certain changes have already been made that would have been considered politically impossible a few years ago. In particular, the rules for automatic indexation have been changed for some benefits or abandoned for others which means that the scope for discretionary action in the future has been widened, notably discretionary action with regard to replacement ratios where this term means the ratio between benefits and previous income. Of course, there can never be any question of scrapping existing welfare structures and substituting something completely new. It is never possible to start building again on a cleared site. The fact remains that there is now some room for manoeuvre and the general economic situation requires that possibilities should not be neglected. The task before each country is therefore to assess the scope for change and to decide where change is practicable and could most usefully be made.

#### Footnotes

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