Dennis J. Snower
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Banking Benefit: Welfare Accounts for the Individual

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THE AUTHORS

Dennis J. Snower is President of the Kiel Institute for the World Economy and Professor of Economics at the University of Kiel, Germany. Before that he was Chairman of the Department of Economics at Birkbeck College. His work examines the operation of labour markets and the welfare state. His recent books include *The Effects of Globalization on National Labor Markets: Diagnosis and Therapy*, (ed.) with Rainer Winkelmann and Klaus Zimmerman (Berlin, 2006).

Alessio J. G. Brown is Head of the research area 'Reforming the Welfare State' at the Kiel Institute for the World Economy and Executive Director of the Global Economic Symposium (GES). He writes on globalization and the welfare state.

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I

Welfare Reform: The Problem

One reason why poor people in developing economies remain poor is that they often do not have formal title to the assets that would enable them to own their livelihood, especially land. So they cannot use these assets as collateral to buy the fertilizer and agricultural machinery that would make this land much more productive. According to Hernando De Soto[1] the total value of fixed property held, but not legally owned, by the poor in developing countries as well as in ex-communist countries exceeds $3.9 trillion. That is a staggering amount – twenty times the amount of foreign investment in developing countries between 1989 and 1999. It is nearly a hundred times the amount of development assistance given to these countries over the past two decades. If they had title to the assets which they use, many of the currently poor people would no longer be poor. There would be a massive upturn of economic activity in countries that need it most.

One reason why property rights are so important is that they make assets tangible so that they can be used to buy other assets. Assets that bestow formal title are easily divided among multiple owners, so that the ownership of a house or a factory can be shared among many people, any of whom could sell their share without needing to take the physical asset apart.

At first glance, this may sound like a strange way of introducing the subject of welfare state reform in advanced, industrialised countries like Great Britain, but it is not. The reason is that the citizens of these countries also have a large stock of assets that are not tangible and thus cannot be mobilised in the public interest. We don't have property title to a significant percentage of our GNP because of the way our tax and benefit systems are structured. In Great Britain, for example, about 32 per cent of government expenditure – 11 per cent of our GNP – is devoted to benefits. These benefits include pensions, benefits for low-income groups, disability benefits, child support, unemployed benefits, and so on. We don't have title to many of these benefits, since they are granted on the condition that we become ill, impoverished, incapacitated, unemployed or disadvantaged in other diverse ways. We as individuals see no connection between our tax payments and benefit receipts. We are under no illusion that an increase in our individual tax payments would necessarily lead to an increase in our benefit receipts. In short, we do not retain title to the tax payments we make.

And that leaves us with the same sort of losses as those that people in developing countries face because they don't have title to their land. Consequently, we often

1 Hernando De Soto (born 1941 in Arequipa) is a Peruvian economist known for his work on the informal economy. He is the president of Peru's Institute for Liberty and Democracy (ILD), located in Lima.

handle our welfare services – covering public unemployment and disability insurance, state health care and education, state pensions, and so on – as ineffectively and inefficiently as poor Africans often handle their land.

In most destitute African countries, the potential demand for agricultural produce is rising, as populations grow and there are more mouths to be fed. But the supply of agricultural produce does not rise to meet the demand. In free markets of capitalist economies, supply and demand are generally kept in balance through the movement of prices: if the demand for a product rises, then the price of that product rises as well, and that induces producers to supply more of it. But the poor African farmers, as noted, are commonly unable to do so because they have no ownership in their land. So prices cannot perform their self-regulating, homeostatic function.

II

The Dysfunctional Welfare State

There has been a rise in the demand for welfare services over the past three decades, which has not been met by a rise in supply. Due to globalisation, skill-biased technological change and deindustrialisation, the distribution of earnings has become more unequal in many OECD countries; in other OECD countries the employment prospects of skilled workers have risen relative to those of unskilled workers. As a result, there is a greater need for income redistribution. The decline of the extended family over this period has accentuated this need, since the informal social insurance among members of an extended family is often no longer available. As people spend more time in post-school education and retire earlier, there is a greater need for lifecycle transfers. In the large continental European countries over the last three decades, unemployment rates of youth and older workers have risen relative to those of prime-age males. This has augmented people's need to transfer incomes from their mid-years (when they are employed) to their early and late years (when they frequently are not). As populations age, the demands for health services and pensions rise.

But in most advanced, industrialised countries, the supply of welfare services has not responded. On the contrary, on account of budgetary pressures, many governments have sought to roll back the finance and provision of welfare services. So the welfare state is not a self-regulating, homeostatic mechanism. Just as human beings' natural mechanisms are vital for their survival – when I am cold I shiver and that warms me up; when I am hot, I sweat and that cools me down – so such mechanisms are essential for the survival of our welfare state. The way to rescue the welfare state – our health and education systems, our pension systems, our unemployment and incapacity benefit systems – is not to raise taxes on productive people and maintain benefits for unproductive ones. That is counterproductive, since higher taxes reduce incentives to remain productive and encourage international outsourcing, whereas benefits granted on the condition of being unproductive discourage work. As a result, the demand for welfare services would rise even more, while the tax base to finance more welfare services would shrink. What is required, instead, is a policy framework that encourages the supply of welfare services to respond automatically to the swings the welfare demands.

There are several other powerful reasons why the supply of welfare services does not adjust to demand. All suppliers of goods and services, whether in the public or the private sectors, need incentives to adjust their offerings to changing customer needs. The most reliable, unambiguous incentives arrive through the forces of competition. When an organization competes with others, then failure to adapt to the customers will often mean going out of business. It is for this reason that competition is so important to generate an efficient allocation of resources. But most welfare states are government monopolies, insulated from competition. Governments often regulate the markets for health, education and various forms of social insurance to abolish potential competition from the private sector. Thus it comes as no surprise that the welfare services offered are unresponsive to the fluctuating demands.

Another important reason for the failure of supply to match demand for welfare services is that the state suppliers have 'soft' budget constraints. It is common for a variety of welfare services – often including health, education, and social insurance – to be financed wholly or in part by general taxes. Consequently, the suppliers of these welfare services face no strong incentive to bring their costs in line with their customers' needs (assessable, for example, through their willingness to pay). Not only does this make the state provision of welfare services inefficient in its own right, it also serves to eliminate private sector competition, since private sector providers generally have 'hard' budget constraints, requiring them to align costs and benefits.

A further reason is the tendency for governments to confuse the requirements of efficiency with those of equity in the provision of welfare services. The unemployment and incapacity benefit systems, for example, are meant to function as a form of insurance against unemployment: the unemployment and incapacity benefits are to be interpreted as pay-outs of this insurance and the tax receipts used to finance these benefits could be viewed as insurance premiums. At the same time, however, these systems are also meant to redistribute income from rich to poor. Thus the 'insurance premiums' are not positively related to the underlying risks; on the contrary, people who are prone to unemployment and disability tend to make lower, not higher, 'premiums'. We do not wish to suggest that the long-term unemployed or incapacitated should be made to pay higher taxes than their long-term employed counterparts; that would be outrageously inequitable. But we do wish to suggest that governments should think more carefully about how to redistribute income *efficiently*. It would be far more efficient to redistribute income through the income tax system than through the unemployment benefit system. The reason is that, subject to various partial exceptions, unemployment benefits are awarded on condition of being unemployed, and thus they encourage people to remain unemployed, but income taxes do not have this characteristic. The same point may be made about a variety of further welfare services. Although the health, education and training systems are also used to redistribute income, these redistribution mechanisms are also far less efficient than the income tax system.

Not long ago, a German journalist asked us whether we thought it scandalous that a rich CEO should pay as much for her health insurance as her secretary. We responded by agreeing, 'Yes, that's a scandal, and it's a scandal that she has to pay as much for her automobile insurance. It's also a scandal that when she goes to a restaurant, she isn't asked to report her income, so that the price of her meal can reflect her impressive purchasing power'. There are many ways of redistributing income: through restaurants, car insurance, health insurance and so on. But none of these is particularly efficient. Governments should make great efforts to redistribute income in ways that do least damage to people's incentives to work, to educate and train themselves, and to save and invest.

III

A System of Welfare Accounts

Thus far we have argued that our present-day welfare state is inefficient and unresponsive to people's welfare needs because people have no property rights in their welfare services. If people 'owned' the funds that finance their unemployment and incapacity benefits, their education and training programmes, their health services and their pensions, then they would have strong incentives not to waste these funds. While efficiency in the supply of welfare services would clearly improve, these property rights would need to be defined in a way that permits sufficient income redistribution to meet the government's equity goals.

Our policy proposal is to restructure the welfare state so as to create such property rights. In particular, our proposal is to replace the current structure of welfare services by 'welfare accounts'. We propose giving every adult four accounts:

- an *unemployment and incapacity account* instead of the current unemployment and incapacity system,
- a *human capital account* instead of the current system of state post-school education and training,
- a *health account* to insure us against any sickness or disability, and
- a *retirement account* to replace state pensions.

Although at first glance this may sound like a radical – perhaps utopian – proposal, it is not. In fact, the welfare accounts could be structured to reproduce all the main regulations and provisions of the current welfare system. In this way the existing welfare system would be treated as a welfare accounts system: taxes that finance the various current welfare services would be people's contributions to each of their welfare accounts and the receipt of welfare benefits and services would be withdrawals from the welfare accounts.

There would be mandatory minimum contribution rates to each account for each individual, and mandatory maximum withdrawal rates, in line with the current welfare state provisions.

In line with current redistribution systems, the government could tax the account contributions of the rich and subsidise the account contributions of the poor. Welfare systems that are currently run on a pay-as-you-go (PAYG) basis – such as the unemployment, incapacity, health and education systems, where current taxes are used to finance current benefits – could be converted to welfare accounts that are also structured as PAYG. In that event, the welfare accounts would implement redistribution not only between income classes, but also between generations.

Furthermore, individuals would be allowed to make transfers among their accounts. At the end of their working lifetime, a person could take the balance left in his or her unemployment account or human capital account and transfer it to his or her pension account or health account. If the balance in one account falls to zero, it could be replenished with excess funds from the other accounts.

People could make voluntary contributions, above the mandatory minimum contribution rates, in order to purchase more than the basic minimum levels of welfare services. Whereas contributions would be taxed or subsidised in accordance with incomes, the withdrawals from these accounts and the capital income funded accounts would be taxed at preferential rates. All the government's redistributions among accounts would be balanced budget redistributions. Thus the welfare accounts would be a closed system, in which the sum of the account subsidies would be equal to the sum of the account taxes.

The government would permit negative balances on the human capital accounts, and individuals with negative balances could be required to repay their debts on an income-dependent schedule, along the lines of current loans for university education in the UK.

Why, you may ask, do we need welfare accounts at all? Wouldn't it be preferable simply to rely on individuals' private savings? There are two solid answers. First is moral hazard: knowing that the government will always support the needy regardless of whether they save or not, individuals will have insufficient incentive to save. The welfare accounts force them to save more. Second is redistribution: as noted, funds are to be redistributed in line with current welfare provisions.

Furthermore, you may ask, why should we replace the current structure by welfare accounts? Although the taxes and transfers associated with the welfare accounts could replicate the current redistribution scheme, the accounts would provide greater incentives for productive activity. How this is possible is most easily seen if we start by focusing on unemployment accounts.

Unemployment Accounts

Once we reinterpret the unemployment benefit system in this way the unused, remaining balances on an individual's unemployment accounts at the end of the working life are fully expropriated. As the system now stands, if a worker has been employed throughout the entire working life and made contributions but never withdrew anything, he or she will not get anything back. Under unemployment accounts, though, the remaining, positive balances are not fully expropriated. Workers will receive a partial refund which can be used to top up their pensions.

Clearly, this government refund in form of a pension top-up must generate employment incentives: the longer you have worked and the less you are unemployed the higher the balance on your account and, thus, your refund. If the resulting incentives are strong enough the account system will be self-financing.

The recent study, by Michael Orszag and us,[2] estimated that the introduction of unemployment accounts in Germany would raise the incentive to work sufficiently to be self-financing and to halve the unemployment rate, whereas in France the unemployment rate would fall by 36 per cent and in Italy by 34 per cent. We assumed that workers who could not finance their unemployment benefits out of their own accounts would receive support under the existing terms and conditions, so that the unemployed would not be worse off than they are in the existing system.

Lastly, you may ask, how do the incentives differ? One way to look at the incentives is by concentrating on the two objectives of the unemployment benefit system: on the one hand it is meant to provide insurance against the income loss of unemployment and on the other hand to redistribute income. Contributions to the unemployment benefit system can be seen as insurance premia and the unemployment benefits can be seen as insurance pay-outs. To avoid disincentives from insurance in the light of adverse selection or moral hazard, 'good risks' need to be rewarded and 'bad risks' need to be punished. This can happen, for example, in the form of payout-dependent insurance premiums and deductibles: the people with low risks of unemployment pay lower contributions and workers have the option of self-financing an initial period of unemployment in return for lower contributions. Such optimal insurance contracts though cannot be implemented together with the second objective of redistributing income. Thereby, redistribution creates disincentives to work.

In contrast, unemployment accounts enable the use of incentive instruments for rewarding good risks, namely the pension top-up or refund of a fraction of the positive account balances on retirement. Thereby, people gain and have property rights in their unemployment benefits. But at the same time they also allow the goal of redistribution to be met more efficiently, as pointed out above, by taxing contributions of the rich and subsidizing contributions of the poor, as it depends on income instead of employment status.

Another way to look at the incentives is to interpret the current unemployment system as rewarding people for being unemployed and penalising them for being employed. When an unemployed person finds a job, much of the benefits are withdrawn, particularly for low-wage, unskilled people, and taxes are imposed. The unemployed impose a cost on the employed, since the latter pay the taxes that finance the unemployment benefits of the former. Thus the current unemployment system reduces the work incentives of both the employed and unemployed.

2 See Brown et al. (2008).

By contrast, unemployment accounts alleviate this externality for when an unemployed person makes withdrawals from his unemployment accounts, he is thereby diminishing the amount of funds that are available to him later on.

The unemployment accounts internalise the externality created by intrapersonal redistributions, i.e. of workers contributing in respect of their own benefits. The traditional unemployment benefit system involves both interpersonal redistribution (the contributions of the employed help finance the benefits of the unemployed) and intrapersonal redistribution (a worker's contributions during periods of employment help finance his own benefits during his periods of unemployment). Under the existing unemployment benefit system both types of redistribution are associated taxes and transfer, thereby, with disincentives. By contrast unemployment accounts internalise the externalities from intrapersonal redistribution (workers finance their unemployment out of their unemployment accounts) and thus create higher employment incentives.[3]

The other welfare accounts generate similar incentives and grant property rights. Training services are analogous to withdrawals from human capital accounts, and the taxes that finance these services are analogous to contributions to the human capital accounts. Human capital accounts could increase people's employability. These accounts could enable people to retrain whenever they considered it appropriate, in response to the ever-changing demands of globalisation and technological advance. Only those people who recognise that it is worth investing in themselves would spend money out of their human capital accounts. They would reason that the higher wages they earned through their additional skills would more than compensate them for the loss of funds in their human capital accounts. The rest of the account holders would keep their account balances and use them to top up their pension accounts or health accounts once they were retired. This would in general be an efficient use of resources, since individuals know better than the government when it is worth investing in themselves.

Under the current healthcare system, people use health services wastefully, since they do not internalise the costs of these services. Yet if they had health accounts, they would need to weigh the value of these services against their costs, since they would pay their health insurance premiums out of these accounts. They would have more freedom of choice, since they could choose their health providers freely, creating competition between the public and private sectors.

The introduction of retirement accounts could be accompanied by further reforms: the minimum retirement age would be linked to changes in life expectancy, and people would have the opportunity to choose voluntarily whether to work beyond this retirement age. The presence of retirement accounts would permit

3 It is on account of the interpersonal redistribution that people are refunded only a *fraction* of their final-period account balances; the rest is redistributed to others.

policy-makers to think more rationally about how the incomes of pensions should be adjusted to unexpected changes in external circumstances, such as oil price shocks or exchange rate shocks. Whereas such shocks are borne unequally by the population under the current system, retirement accounts would permit governments to spread the costs equitably across the population, whether working or retired.

IV

How the System Would Work

How can the UK move from the present benefit dependency system to a framework for unemployment accounts?[4] What are the political or administrative difficulties that would need to be overcome? Which of the existing rules, regulations and procedures would need to be changed? The answer is very simple: none. Neither the contributions and benefits nor the rules and conditions for eligibility, duration of payment, the amounts paid, taxes and transfers need to change.

Only one simple, new provision need be added: at the end of his or her working life, each individual can gain access to a portion of the balance that remains on the unemployment account. The individual might get this amount as a lump sum, an annuity that tops up the pension or, if available, transfers to his or her health account.

To implement this provision, it will be necessary to keep track of the individual's contributions (including any taxes that fund unemployment insurance) and withdrawals (unemployment benefits paid) in order to calculate the individual's unemployment account balance at the end of his or her working lifetime.

While this accounting exercise may involve some cost – that of installing the relevant information system – it is worth keeping in mind that this policy will inevitably be very popular among the electorate. The reason is that the vast majority of employed people, who pay contributions while making few, if any, withdrawals, are dispossessed at the end of their working lives: they receive none of the difference between the present value of their contributions and the present value of their withdrawals. Under unemployment accounts, by contrast, they would gain access to a portion of this difference. In short, the proposed unemployment accounts system gives them a pay-out, while the current unemployment benefit system does not.

How is this pay-out to be financed? The electorate should know what is at stake. The answer is simple: by providing this extra pay-out, the unemployment accounts system creates new employment incentives. Whereas the current unemployment benefit system rewards unemployment (through the unemployment benefits) and penalises employment (via the contributions necessary to finance the unemployment benefits), the unemployment accounts system rewards work. For the longer a person is unemployed, the greater are the associated withdrawals, and the lower is the account balance available to that person at the end of his

4 We have provided a detailed account of how to introduce unemployment accounts in Germany in a paper together with Alfred Boss, see Boss et al. (2008).

or her working lifetime. The new employment incentives created through the unemployment accounts system lead people to generate new goods and services, which in turn generate more income. The taxes on this extra income, combined with reduced unemployment benefits paid, finance the extra pay-out from the unemployment accounts system.

In short, the unemployment accounts system provides an extra pay-out or 'free lunch'. A well-known principle of mainstream economics is, however, that 'there ain't no such thing as a free lunch' in free market economies. But this principle only holds in the absence of economic inefficiencies generated through government interventions, public goods, and the like. The current unemployment benefit system is a massively inefficient government intervention, since the unemployment benefits reduce the unemployed people's incentives to work and the contributions that finance these benefits reduce the employed people's incentives to work. Replacing this system by a more efficient one – unemployment accounts – reduces the amount of waste in the economy and releases new productive activity. The income from this new activity can be used to provide the extra pay-out (the 'free lunch') from the unemployment accounts system.

This, you might think, sounds OK in theory, but how can we be sure that the extra employment incentives will be sufficiently large to enable us to provide the specified extra pay-out? To answer this question, the employment incentives must be evaluated. In a recent empirical study,[5] we show that, for very conservative estimates of people's response to unemployment accounts, the resulting employment incentives are more than sufficient to finance a substantial pay-out for those with positive balances, while guaranteeing that those with zero balances receive no less than they do under the current unemployment benefit system.

Furthermore, there is the well-known, infernal problem of transition to the new system. Like traditional pension systems, the current unemployment benefit system is run on a pay-as-you-go (PAYG) principle, whereby the current contributors finance the current recipients of unemployment benefits. Does a switch from the current system to the accounts system mean that the current generation pays twice – past contributions to the current system and further contributions to finance the payout from the accounts system? The answer, for two reasons, is No.

First, the unemployment accounts system can be run on a PAYG basis, so that the contributions of the currently employed people pay the benefits and terminal pay-out from the accounts. There is no need to make the unemployment accounts fully funded – although policy-makers may wish to pursue this course in the longer run. Second, under these circumstances, the transition generation does not pay twice, provided that its right to the terminal pay-out is adjusted pro rata to take account of the length of time over which contributions are made.

5 See Brown et al. (2008).

A simple example can clarify the second point. Suppose that Person A, enters the workforce after the unemployment accounts system has been introduced – and works continuously for 40 years, contributing £1000 per year, before retiring. Then, under the simplifying assumption that the interest rate is zero, his account balance at the end of his working life is £40,000. In order to pay the benefits of people with zero balances and undertake the existing amount of redistribution, suppose that this account balance needs to be taxed at the rate of t. Then Person A's terminal pay-out is (1-t) x £40,000.

Next, consider Person B, who also works continuously for 40 years before retiring, but who has spent the first 20 years under the old unemployment benefit system and the last 20 years under the unemployment accounts system. Then Person B's terminal pay-out is (1/2) x (1-t) x £40,000, since he has only spent half his working life under the accounts system.

Finally, as noted, it is possible to convert the unemployment accounts system from PAYG to a fully funded system. Recall our finding that the employment incentives are more than sufficient to fund the terminal pay-out for people with positive account balances while guaranteeing that people with zero balances receive the same benefits as under the current system, These 'surplus' incentives can be used to finance the transition to the fully funded system, without requiring the transition generation to pay twice. The transition period, however, would have to be sufficiently long to permit the surplus employment incentives to cover the transition cost.

V

A More Efficient and Equitable Welfare System

Although, as noted, the welfare accounts could replicate the provisions underlying the current welfare system, their most important potential contribution – in our opinion – lies in the policy reforms to which they would lead. By making redistributions among account-holders transparent, the account system would generate political pressure to modify these redistributions in accordance with the public interest. For example, in the current welfare system, the redistributions do not go primarily from the rich to the poor. The lion's share of the redistributions takes the form of lifecycle transfers, mainly from the middle years to the early and later years. For most European countries, 20-25 per cent of social transfers actually redistribute income between individuals (inter-personal redistributions), and the remaining 75-80 per cent transfers income across people's lifecycles (intra-personal redistributions). The welfare account system would give people incentives to conduct these intra-personal, inter-temporal transfers as efficiently as possible. In contrast to the current welfare system, the account system would give people property rights in these inter-temporal transfers. This would enable the government to refocus welfare provision on the 20-25 per cent of transfers devoted to inter-personal redistribution.

The welfare account system would also promote competition in the provision of welfare services. The private sector has an incentive to contribute to the welfare state only if it is impossible for the government to use the tax and transfer system to drive the private providers out of business. This is what happens in the current welfare system. But under the welfare account system, the government could not do so, since its welfare expenditures would have to be financed exclusively from the money it receives out of people's welfare accounts. Then the private and public sectors would compete on a level playing-field.

The standard argument against accounts is that they endanger social solidarity. We would argue that the current system, with its steadily increasing contribution rates and arbitrary benefit cuts, is a much greater threat to social cohesion and solidarity. Welfare accounts would be much more transparent, and that would enable us to achieve our redistributive aims much more effectively.

Since welfare accounts would be more transparent, they would enable politicians to build coalitions of voters favouring the account system, so long as the government guaranteed to maintain existing benefits for existing recipients. Welfare accounts would be popular among young people, who have little confidence that the current system would support them adequately if they become needy. Under these circumstances, a government's ability to renege arbitrarily on its obligations to society could be curtailed.

Welfare accounts promote adaptability by giving people property rights in welfare services. These property rights enable people to internalise more of the costs and benefits of the welfare services and thereby they induce people to use these services more efficiently and adjust them automatically to their changing employment, skill acquisition and pension needs.

For all these reasons, welfare accounts would enable countries to provide welfare services more efficiently and equitably.

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info@politeia.co.uk

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