Seminar Paper No. 389

INDIVIDUAL FREEDOM AND WELFARE STATE POLICY

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In economic theory, the individual (or household) is basically assumed to be concerned with the bundle of goods and services which it actually obtains, including leisure and job characteristics. The process by which this bundle is reached plays no role for how the household evaluates it -- for instance, whether the individual itself has chosen the bundle or whether the individual has instead been provided the bundle by somebody else, such as the government. This means that the issue of "individual freedom", which is closely related not only to actual achievements but also to the process by which these are realized, is seldom squarely confronted in economic analysis. However, just such a confrontation will be attempted in this lecture. As we shall see, this raises some basic issues of welfare economics and cost-benefit analysis, in particular concerning the specification and interpretation of the preference function, and even the general justification, in the context of normative economics, for the

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¹ I am grateful for helpful comments on an earlier draft from William Baumol, Thorvaldur Gylfason, Mats Persson, Amartya Sen, Dennis Snower, Lars Svensson, and Jörgen W. Weibull.

traditional partitioning between a subjective preference function and an objective opportunity set.

Generally speaking, individual freedom has to do with the tightness of various types of constraints on the decisions and actions of individuals. However, as this lecture is confined to the consequences of welfare state policy, it is not necessary to deal with the complex issue of "freedom" in all its philosophical aspects.²

Indeed, the analysis concentrates on three aspects: (i) the freedom of choice with respect to goods and services; (ii) the predictability of the consequences of such choice, and (iii) the privacy and personal integrity of the individual, which may be regarded as two specific types of abstract "goods". The reason for concentrating on these three aspects of individual freedom is that welfare state policies have profound consequences for each of them. It will also be assumed that the individual regards freedom per se as valuable, even though the opposite opinion is sometimes expressed, mainly due to asserted psychological disadvantages for the individual of having to choose among alternatives.³

By way of introduction, it is also necessary to decide what types of welfare state policies should be considered. This exposition concentrates on a collection of policy instruments that are recorded on

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2 When trying to make a useful conceptualization of individual freedom, I have found the writings of Gray (1980), Hayek (1960), Machlup (1969), Nozick (1974), Sen (1985a) and Sugden (1981) particularly useful.

3 Of course, there are situations when the individual may want to commit himself in advance to certain future actions, for example to avoid that others would exploit his ability to act freely at every point of time; for game-theoretic analyses of such situations see, for instance, Schelling (1960) and Lindbeck and Weibull (1987). However, voluntary decisions to commit oneself in the future can hardly be regarded as reflecting a negative attitude of the individual to freedom per se.

the public budgets, namely, social security systems, money transfers to households, and government subsidization and/or provision of certain types of goods and personal services to households, such as health services, child care and old age care -- as well as the financing of such programs. Macroeconomic stabilization policy and various types of regulations will basically be left outside the present discussion. An exception is that price control and related rationing will be considered -- one reason being that price control has obvious similarities with subsidies, another and more fundamental, that price control and rationing are paramount in the case of public services.

~~When discussing individual freedom, it is important to remind~~ ourselves that certain government-implemented limitations on freedom are a prerequisite for other types of freedoms. The most obvious example is perhaps legally imposed limitations on the freedom of one person to use force against others -- i.e., government protection against "the tyranny of anarchy". For instance, government-guaranteed property rights and transaction rights are certainly a sine qua non for voluntary exchange, and hence for "economic freedom".⁴ A well-known dilemma, though, is that the same government that has removed "the tyranny of anarchy" often itself violates the very same rights, which places our societies in a precarious dilemma "Between Anarchy and Leviathan", to quote a well-known title of a book by James Buchanan (1975).

It is also important to remember, throughout the lecture, that conceivable damage to individual freedom of welfare state policies, in particular its financing, has to be compared with conceivable gains in other respects. Indeed, it is obvious that such gains are both far-

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4 For discussions of the importance for individual freedom of various rights, see Dworkin (1978) and Kanger (1975).

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reaching and impressive in several modern welfare states: (i) in mitigating destitution among groups of citizens that would otherwise live in poverty, including physically and mentally handicapped citizens; (ii) in stimulating investment in human capital, in particular in health and education; and (iii) in helping individuals to reduce uncertainty of income in connection to market risks, as well as to smooth their consumption path over lifetime, in particular for individuals who are not able, or willing, to do that all by themselves by way of private saving and private insurances. On the basis of such achievements, I have in earlier writings characterized the build-up of the modern welfare state, up to a point, as a "triumph of modern civilization" (Lindbeck 1988).⁵

However, as we shall see, there is not always a conflict, as often envisaged, between such achievements, on the one hand, and related reductions in individual freedom, on the other. Some welfare state programs tend to increase rather than reduce individual freedom in certain important respects, at least for some individuals; and some welfare state programs, and their financing, may, as we shall see, reduce rather than enhance economic security.

Moreover, as the relevant political issue is not if the welfare state should be abolished or not, but rather if it should be expanded or contracted from existing levels, we do not have to ask the "impossible" question whether the welfare state as "a whole" has increased or reduced individual freedom. It is usually enough for our purpose to ask about

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5 Of course, the public sector makes many other contributions to individual welfare, such as the provision of public (collective) goods, interventions in connection to externalities, etc. However, as these types of public sector activities are part of the classical role of government, i.e. to provide collective goods, rather than of welfare state programs, I will not discuss such actions in this paper.

the consequences for individual freedom of changes in various welfare
state programs. We will then occasionally find that a certain welfare
state program, and its financing, has increased individual freedom in
some dimensions, at least for some individuals, and reduced it in other
dimensions.

(i) Freedom of choice

It is convenient to start with the freedom of choice of
consumption, leisure, types of work, etc. -- an aspect which may be
regarded as a sub-category of the wider concept of "individual freedom".
~~Such freedom of choice will be analyzed here in terms of the opportunity~~
~~set and/or the potential options of the individual.~~ The term
"opportunity set" then refers to what the individual may achieve by
available resources, i.e., largely his initial wealth, possibly further
restricted by non-budgetary constraints, while "potential options" refer
to states which the individual would be able to achieve if initial
wealth was not a constraint. Four features of freedom of choice will
then be studied: (1) the importance for freedom of choice of the
"command over resources" by way of wealth; (2) the possibility of the
individual to improve his economic situation, and utility, by his own
actions; (3) non-budgetary constraints on the opportunity set, such as
formal or informal rationing of goods and services; and (4) restrictions
on options that the individual does not consider to choose, i.e.
removals of what may be called "apparently irrelevant alternatives".
These four features will be explained below, partly by the help of two
simple diagrams.

(1) Let us first look at the command over resources by way of individual wealth. While there is rather widespread agreement among writers on individual freedom that property rights and transaction rights are important for the freedom of choice, there is less agreement whether the wealth position itself should be regarded as a factor which informs us about the extent of freedom of choice. Without arguing that one definition of freedom of choice is necessarily better than another, it is certainly useful to include wealth as a factor that influences the freedom of choice when the latter, as in the present lecture, is largely analyzed in terms of the individual's opportunity set, for which wealth plays a crucial part. Then we also avoid confining the notion of freedom of choice just to formal rights, such as the right of both the poor and the rich to buy attractive goods or to enter excellent schools, regardless of their possibilities to finance such actions. Our terminology also implies that lump-sum taxes and lump-sum benefits will influence the freedom of choice, and that government policies which bring about redistribution of wealth in favor of poor sections of the population will be said to expand the freedom of choice for people who originally had relative little of it.⁶ To the extent that welfare state

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6 Examples of social philosophers who object to the idea that wealth should be regarded as a component of individual freedom are Isaiah Berlin (1968), Friedrich von Hayek (1960 and 1973-79) and John Rawls (1972). They seem to prefer to regard wealth as a factor that enables the individual to get out more pleasure (or more "worth" in Rawls's terminology) from existing "freedom", rather than as a component of freedom itself, which is then, in fact, asserted to be constrained by non-budgetary rather than budgetary constraints, such as restrictions on property rights and transaction rights. Thus, these authors make, in fact, a distinction between the ability to buy goods and services, due to holdings of wealth (which they do not regard as a component of freedom) and the freedom to exercise this ability -- a distinction used also by, for instance, Jensen and Meckling (1977)). This distinction between budgetary and non-budgetary constraints is related to, though not congruent with the traditional distinction between "positive" and "negative" freedom.

policies bring about such redistribution, here is then an example where welfare state policies may increase the freedom of choice for some people, though at the expense of others.

It is also conceivable that the attitude of the individual to constraints on his freedom of choice differ depending on who has imposed them. For instance, we may speculate that the individual feels that his freedom of choice is more constrained if it is the government that takes wealth away from him, for instance, by way of a tax increase, than if "nature" does it, for instance, via an unfortunate ("unlucky") outcome of his own actions. One explanation may be that the individual in the former case feels that other human beings, or human institutions, have arbitrarily constrained his command over resources, while in the latter case some purely "exogenous" force, which human beings may not be able to do anything about, is responsible. The distinction is particularly important if, following writers like Berlin (1965) and Hayek (1960), we argue that "freedom" has more to do with restrictions on human behavior that are, directly or indirectly, imposed by other human beings, than with constraints imposed by nature. Another explanation may be that the individual, subjectively, feels that his property rights in factor incomes, which he has earned, are violated by taxes, while hypothetical increase in factor income that could have been earned, but have not

materialized, are not connected with such subjectively felt property rights.⁷

(2) However, it is obvious that important aspects of freedom of choice cannot be dealt with solely in the context of changes in wealth, and related changes in traditionally defined utility. In particular, it is reasonable to say that freedom of choice is reduced also when the possibility for the individual to influence his situation by his own actions is reduced by government policies -- even though the wealth position, or the traditionally defined utility, of the individual does not deteriorate. To clarify this point, it is useful to think first about the extreme situation when the marginal income tax rate is one hundred per cent, so that the individual cannot improve his income by his own effort in markets -- whether the labor market or the capital market. All observers would in this case probably agree that the freedom of choice of the individual has been severely restricted by the government, in the sense that he cannot "trade" income for leisure (in a broad sense of the latter term); indeed, taxes in this special case function like a law that forbids increased incomes from additional work effort. However, the same observers would probably also agree that a considerable reduction in the freedom of choice occurs already with marginal tax rates below one hundred per cent, as then it may be very

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6 It is worth noting that the so-called "regret theory" (Loomes and Sugden 1982) postulates just the opposite evaluation of the outcomes of exogenous events and actions by the individual itself, respectively. For when that theory asserts that the individual would be unhappy (feel regret) that he did not behave differently when there is an unfortunate outcome of his own action, while no such regret would be felt in the case of an exogenous event such as a tax increase -- if that theory is not widened to include regret about how the individual voted in the last elections! However, in the case of unexpectedly positive outcomes, regret theory seems to be consistent with the arguments in this lecture, as regret theory asserts "rejoyce" in connection to such an outcome if it has resulted from actions taken by the individual himself.

difficult, though not completely impossible, for the individual to raise his money income by, say, twenty or even ten per cent, in spite of the fact that he could easily increase his pretax income at those rates by extra effort. The individual is largely "trapped" in a certain income bracket by government policies, with very little possibility of changing his economic situation by his own effort, even if he is anxious to do so, and even if there are no "natural" limitations to such a change. For instance, in the perhaps most "advanced" welfare state in the world, Sweden, where the average full-time employed person has a marginal tax rate of 75 percent (when all taxes and income-dependent transfers are included), it is obvious that the ability of the individual to choose freely between income and leisure has been drastically restricted by government tax policy.

Generally speaking, it is reasonable, as a partial ordering, to talk about a government-induced reduction in the freedom of choice when marginal tax or subsidy rates distort individual decision-making by the creation of "wedges" between the private and social returns on factor supplies, and effort in general. Obviously, this type of limitation on individual freedom of choice is closely connected with the traditional concept of "dead-weight costs" of government-induced relative price distortions. We may say that traditional analysis of tax-wedges, and related dead-weight costs, in the discussion above has largely been reinterpreted in terms of the concept "freedom of choice". However, as we shall see subsequently, such a reinterpretation has some interesting consequences for normative economics.

In figure 1, let q_1 and q_2 be the quantities of two goods, and let AB be the budget line, with the chosen point a on the highest possible indifference curve, u_1 . Thus, while a deterioration (improvement) in

FIGURE 1

the freedom of choice by way of a government-imposed reduction

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(increase) in the wealth position of the individual (even by lump-sum taxes or transfers) is simply reflected in a downward (upward) parallel shift in the budget line, reduced freedom of choice by way of a distortion of the relative price is represented as a change in the slope of the consumer's budget line. As an extreme example of the latter, letting q_1 be leisure and q_2 income, respectively, a one hundred per cent marginal income tax rate means that the individual will be stuck at a point on the vertical line BD, i.e. at an income level where the government chooses to place him by way of transfer payments.⁸

For instance, if the government provides the individual with the income OE, the opportunity set changes from OAB to OEbB, which means, in fact, that the government places him at point b. Even though the individual is now provided a level of income that gives him the same, traditionally defined utility as initially (at indifference curve u_1), he is now in a situation where he cannot, by his own effort, change his income, while at point a he could do just that, if he so wanted. In this specific sense, the individual has less freedom of choice with the new budget set OEbB than with the initial budget set OAB, even though the maximum attainable, traditionally defined, utility is the same for

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8 This geometric representation assumes, without loss of generality of the argument, that the individual does not enjoy work per se. If he does, the vertical line BD will be to the left of the point of maximum leisure, or more precisely at the point where utility is maximized for the given income level, which in the simple case of separability in the utility function occurs when the marginal utility of work and leisure are the same.

In a similar way, the individual's freedom to reallocate income and consumption over time will be reduced by marginal income tax rates that reduce the return on saving and investment in financial or physical capital -- though not even 100 per cent marginal tax rates will eliminate the possibility of the individual to bring about such reallocations (by contrast to the consequences for the choice between income and leisure of 100 per cent marginal tax rate).

both opportunity sets. If the individual has a positive evaluation of the act of choosing as such between income and leisure, he would therefore prefer to choose point a rather than being provided the income level OE. Accordingly, we may argue that there is a hypothetical income transfer, in addition to Bb, that would exactly compensate the individual for the loss in the freedom of choice at point b. Of course, we do not know, with the information provided in this example, how large this income transfer would have to be, for instance whether it would have to move the individual up to, or even above point c, where the level of income is the same, and leisure is larger than at the initially chosen bundle of point a.⁹

Though this analysis has been pursued by traditional tools of economic analysis, a modification of conventional utility functions is certainly necessary to incorporate the notion of a value of the act of choosing itself. One way of doing just that may be to include the entire opportunity set in the preference function, beside the actually consumed bundle, which means, of course, that the traditional partitioning between a "subjective" preference function and an "objective" opportunity set would have to be given up. The individual is assumed to value all existing opportunities, or "advantages" in Sen's terminology (1985a, 1985b). For instance, in the special case when there is an unambiguous reduction (increase) in the opportunity set, in the sense that the new set is strictly inside (outside) the old, it is tempting to argue that the individual unambiguously has lost (gained)

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9 It is tempting to argue that transfer payments of the amount OA, which would make the individual choose point d, is preferred by the individual to being able to choose freely along the budget line AB, as the opportunity set OAdB dominates the original budget set OAB. However, not even that assertion is selfevident, as the individual may be upset, in principle, by the fact that the government has removed rewards to variations in work effort.

freedom of choice; (see, however, the reservation to this point in footnote 9). In the more general case, when part of the new opportunity set is inside but another part outside the original opportunity set, that simple approach does not give unambiguous results.¹⁰

A more appropriate way of formalizing a positive evaluation of the act of choosing in situations with price distortions may be to include the price distortion itself, for instance in terms of the size of the tax wedge, as a separate argument in the preference function. In other words, the utility function would read $U(q,t)$, where q is the consumption bundle and t , representing for instance a tax-wedge, expresses government-imposed restrictions on the ability of the individual to trade one type of good for another; $U_1 > 0$, $U_2 < 0$. For instance, a one-hundred per cent marginal tax rate would then reflect the individual's evaluation of not being able to choose income level at all, while a smaller marginal tax rate would express the evaluation of a partial elimination of that ability.

The partial character of this analysis should, of course, be emphasized. It is, in a more complete analysis, necessary to consider also the consequences for freedom of choice of the spending programs that are financed by the taxes under considerations. For instance, as pointed out above, such spending may increase the freedom of choice of some individuals by raising their wealth. I will give other examples later on how public spending may increase freedom of choice. It might

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10 It is in that case necessary to weigh each area relative to the preferences of the individual, i.e. to integrate the utility function over the areas in question. We would then argue that the freedom of choice is greater at point a than at point b if the utility-weighted area OAB is larger than the utility-weighted area OEbB.

For discussions about evaluations of entire opportunity set, see Kanger (1975) and Sen (1985b, p.21). For assertions that freedom is primarily a descriptive concept, and that it can be defined in an objective fashion, see Oppenheim (1973), Day (1970), and Parent (1974).

also be argued, though I am not prepared to do so, that the individual (by rational expectations) may be aware of the possibility that lower marginal tax rates would influence factor and product prices, which in the analysis above have been taken as given by the individual, and that such changes could influence the freedom of choice.

(3) Additional light may be thrown on the issue of freedom of choice by looking also at the consequences of non-budgetary restrictions on the opportunity set, in the form of formal or informal rationing of goods and services in connection to "scarcities", i.e., excess demand. The freedom of choice of the individual is then limited in the sense that he is provided a different consumption bundle than he would choose himself at the existing budget restriction; i.e., there is a discrepancy between the desired and the provided consumption bundles at given wealth and relative prices, by contrast to earlier discussed limitations in freedom of choice when markets were in equilibrium, though at distorted relative prices.

In figure 2, let us assume that good 1 is rationed in the quantity OF. The opportunity set of the individual is accordingly cut down to the area OAeF, which is unambiguously smaller than the initial budget set OAB; moreover, the originally most preferred bundle, a, has been removed from the opportunity set. The individual would now have to settle for the corner solution e, rather than being able to choose the original optimum bundle a. The point I want to make is that the individual in this case, in addition to a conventional utility loss, is "frustrated" by not being able to achieve the consumption bundle that is optimal at existing wealth and relative prices, as expressed by the budget set OAB.

FIGURE 2

To clarify this frustration effect, let us alternatively assume that the government reduces the price of good 1 by way of a price regulation, and that the new budget set therefore is ODC in figure 2, so that the individual now would like to choose the bundle d.¹¹ But suppose that he is in fact instead provided the initial bundle a, by way of informal or formal rationing of both goods, or simply by government decree. In other words, the opportunity set is now the bundle a, though the budget set is ODC. Even though conventionally defined utility is the same as initially, i.e. U_1 , the freedom of choice has been reduced, as the individual has been robbed of alternatives. Assuming, again, that the individual evaluates the act of choosing positively, the individual is now less satisfied than when he originally freely did choose the same bundle, i.e. point a.

Thus, my hypothesis is that the individual is "frustrated" if he is given economic incentives to desire a better consumption bundle (such as point d in the example above), which he then is prevented from achieving because of rationing or government decree. Assuming that this frustration effect can be interpreted as a loss in satisfaction, there would, in principle, be a hypothetical lump-sum increase in income, which would make him indifferent between being provided the bundle a when he desires another bundle, on one hand, and being able to choose the same bundle freely along the budget line AB, on the other hand. It is in exactly this sense that rationing may create a frustration effect, in addition to a possible loss in conventionally defined utility. It may also be hypothesized that the individual feels particularly

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11 In the case when q_1 is leisure and q_2 income, a similar shift may be achieved by an income¹ tax in combination with a lump sum transfer; the new budget set would then be ODEB in figure 2, where the lump sum transfer is BE.

"frustrated" if he regards the rationing system as "unfair", for instance when people with high positions in society, and good contacts, are favored, as seems to be a typical feature of many system of rationing, in particular informal rationing, for instance in rent controlled housing markets.

One conceivable analytical representation of such a frustration effect is to postulate that not only the actual consumption (and asset) vector (q), but also the desired one (q^*), is an argument in the utility function: $u(q, q^*)$, with $u_1 > 0$, $u_2 < 0$, where q^* is assumed to depend on actually existing (possibly non-market clearing) income and prices.¹² (In the example in Figure 2 above, q and q^* then depict the bundles a and d, respectively.)¹³

In other words, suppose that the individual, at the price vector p , in Walrasian equilibrium, chooses the consumption (and asset) vector q . Let us then assume that the government introduces price controls on some goods, and that the individual at the new price vector $p^* < p$ wants to obtain the vector $q^* > q$, but that he is unable to get it because of excess demand in some markets. Assume further that the government now

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12 The latter may not be a self-evident assumption when prices are non-clearing. For if the individual has "rational expectations" concerning the alternative scenario without price control, it may be argued that he should compare the bundle that he actually gets not with the consumption bundle that he would like to have at the regulated price, but rather with the consumption bundle which he would choose if price control was removed and prices adjusted accordingly. In the discussion above, I have assumed that it is the existing price vector that determines the aspiration level, and then also influences the frustration effect. Maybe we can say that I subscribe to the notion of "bounded rationality" rather than rational expectations.

13 Formally, this specification of the utility function is similar to the analysis of "envy effects", where q^* is then related to the consumption level of other agents.

instead provides him just the initial vector q .¹⁴ We may now say that freedom of choice has been reduced, and we may hypothesize that the individual therefore feels less satisfied than initially. One specific analytical representation of the frustration effect along this line would be the conventional consumer's surplus, measuring the utility loss to the individual of consuming the bundle q rather than q^* , i.e. the difference between utility levels U_2 and U_1 .¹⁵

This analysis also illustrates the importance of including wealth as a factor that contributes to freedom of choice. Because, otherwise we would, in the context of the analysis above with unsatisfied demand, be forced to say that the government may increase the freedom of choice of the individual simply by reducing his product demand, and hence his aspiration level, q^*_1 , (as $U_2 < 0$), by policies that reduce the individual's wealth (provided the good is a normal good).¹⁶

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14 As $p^*q < pq$, we have, in order to get a consistent comparison, to assume that the government also introduces a lump-sum tax equal to $pq - p^*q$ in the case of rationing; otherwise the individual will have income "left over" in the rationing case.

15 This specific measure of the value to an individual of having, rather than not having the liberty to buy a desired good, seem to follow immediately from the traditional definition of consumers' surplus (Hicks, 1939, pp.38-41). Such a measure of the value of the right to choose freely has indeed recently been suggested by James Buchanan (1987).

16 Obviously, the "domain" for the argument in the text that freedom of choice is systematically related to the difference between desire and outcome is a limited one. I suggest that the case discussed here, where the government creates economic incentives for increased consumption but prevents the individual from realizing his new desire, is a proper "domain" for the argument, while the "brainwashing", via force or one-sided propaganda, of people to be content with what they have, is not a proper domain for the argument. In other words, the idea of freedom of choice presupposes value-pluralism and an open society in the formation of opinions. Berlin's (1968) and Popper's (1945) conception of individual freedom emphasizes, of course, the importance of "value pluralism" for a society to be regarded as "free".

Another important example of a government-induced frustration

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effect is when the public sector provides non-marketable, tax-financed public transfers in kind, free of charge or at highly subsidized prices. The household has then to give up money income, i.e., general purchasing power, in exchange for services that cannot be resold in the market, i.e., services which have a zero market price for a potential private seller. The limitation on the freedom of choice, and the related frustration effect, consists here of the non-marketability of the provided goods, in combination with the tax-induced reduction in money-income, which means that the individual have rather limited resources to buy goods others than those that are provided by the government. The individual may then have too much publicly provided non-marketable goods relative to other goods. This may also mean that the possibility for the family to take care of its own children in the daytime may be eliminated, as the household may feel that it really has no choice other than to have both parents working outside the home, to obtain higher money income in order to get more of "ordinary" goods, and to hand over the care of their children to free or highly subsidized institutions.

Exactly this has indeed happened in Sweden, due to the combined effects of high average tax rates and ample provision of non-marketable government services in kind. Hardly any family with children in Sweden thinks today that it can afford to take care of their own children in daytime. Even a household headed by a "high-income" employee, like a military colonel or a university professor for that matter, in Sweden would today wind up with a money income below the official poverty level, i.e. with an income where social welfare may be received, if the household has three children and only one income earner. (Du Rietz, 1987.) However, if in fact such a family would apply for social welfare

payments, the family would be denied it with the argument that both parents should take jobs in the open labor market and hand over the children to day care outside the home, even though one parent would otherwise (at lower public spending and lower taxes) be eager to stay at home to take care of the children for some years. Freedom of choice, in a presumably very important dimension of life, has then been eliminated.

An additional frustration effect in connection to the provision of publicly provided goods may arise if the public goods are rationed, as they usually are in the real world; the implications of such rationing have, however, already been discussed in the previous section in connection to price control. A third type of constraint on the freedom of choice would occur if, moreover, public institutions have monopoly positions, or near monopoly status, in the sense that private alternatives are either legally not allowed, or discriminated against so much by subsidies to public institutions that private alternatives, which would otherwise exist, cannot survive in the market. Product variety would in these cases be reduced by government actions. Citizens who would like to have another type of health service, school, child care, old age care, or insurance than the ones that are provided by government monopolies, would then have no possibility of choosing something different -- even though it is not obvious why freedom of choice among alternative products and product varieties would be less important in fields like these than, for instance, for different types of automobiles and toothpastes.

The basic reason why it makes sense to say that monopolies imply a restriction on the freedom of choice of the individual is, of course, that such freedom presupposes alternatives that provide substitute modes of actions for the individual. Moreover, when considering the

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consequences for freedom of choice of public monopolies, it is also

important to remember that such monopolies remove alternative employers, and hence varieties of job for employees.

An analytical representation that would make justice to the idea of a reduction in the freedom of choice due to monopolies would require the same number of dimensions as the number of goods, or product varieties; the removal of one alternative would then be represented as a loss of one dimension. Alternately, we might want to choose a continuous representation of product variety à la Lancaster (1979), in the form of a circle of product characteristics, or à la Dixit and Stiglitz (1977), in the form of a straight line of product varieties¹⁷. The creation of government monopoly would then be depicted as a removal of some segments of this circle (line).

In principle, it is, of course, possible to avoid such public monopolies even if there are compulsory insurance, and subsidization of certain types of services. In particular, private citizens could in principle be allowed to choose insurance company even if insurance is compulsory; and subsidies may be provided on equal terms for both public and private producers, possibly in the form of voucher systems.¹⁸

What are then the reasons for the strong discrimination against private alternatives for services like education, health, child care and

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17 More generally, D. and A. Gabor (1979) have developed a very general mathematical framework where freedom is analyzed in terms of the variety of choice in life.

18 A complicating factor when judging the welfare consequences of subsidized public services is, of course, that such subsidies may have distributional consequences, in particular between three groups of households: those who would prefer the public alternative even without the subsidies, those who because of the subsidy are induced to shift to the public alternative, and those who would like to stick to the private alternative also when the public service is subsidized.

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old age care in many welfare state nations? "Paternalism" is probably an important part of the answer. Indeed, it is typical for the modern welfare state in capitalist countries to direct "paternalism" towards households rather than firms -- by contrast to socialist countries where paternalism seems to be directed towards both. Indeed a useful distinction between socialist states and welfare states is that while the former tend to nationalize and monopolize firms of all types, welfare states mainly nationalize and monopolize market production and household production of personal services, including insurance, to household members -- as well as much of the factor incomes of the household, via the tax system.

One obvious explanation for such paternalism towards households is a desire among politicians to control the quality and the detailed distribution (i.e., what each individual gets) of certain services. Behind these policies there probably often lie basic objectives of avoiding social segregation of people -- children as well as adults. In some countries, public services in fields like child care and education may also reflect an ambition among politicians and public administrators to "homogenize" the population, as the family institution is often regarded as an obstacle to such homogenization, by perpetuating inequality and diversity of values and attitudes. For these various reasons, "freedom of choice" in fields like child care, education,

health care and old age care is, no doubt, regarded by some politicians and public administrators as an "evil" rather than a value.¹⁹

(4) The asserted "frustration effect", discussed above, was caused by a discrepancy between the desired and the provided consumption bundle. However, we may want to go a step further, and argue that the individual also regards the removal of "apparently irrelevant alternatives" as an infringement on his freedom of choice. By that term I then mean bundles, whether inside or outside the opportunity set, which the individual does not consider to choose. We may then hypothesize that a removal of a subset of the original opportunity set OAB in figure 2, but with the chosen point a retained, would be regarded as a loss of freedom of choice, even though the removed alternatives are "irrelevant" in the sense that the individual does not want to choose them, and thus there is no "frustration" due to a difference between demanded and actually provided bundles. For instance, an individual may regard the removal of all alternatives south-west of point a as a loss in freedom of choice, and in personal satisfaction, even though he still wants, and is still able to choose the bundle a. Indeed, these assertions tie in to the earlier discussed assumption that freedom of

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19 It is sometimes argued that the elimination of public monopolies would reduce the product quality of the publicly provided good. The asserted reason would be that those who initially are induced, or forced, to consume a public good, like public day care centers, but who without discrimination of private alternatives would shift to these, usually are better educated and more vocal than those who would stick to the public alternative. In other words, it is assumed that those who choose the "exit" option are also able to use the "voice" option more effectively than others. (For assertions along those lines, see Hirschman (1981), Nelson and Krashinsky (1973), and Young (1976)).

On the other hand, a public supplier would get stronger incentives to listen to voice if exit is allowed. In other words, it is not clear whether exist and voice are complement or substitute modes of influencing product quality of this case. Thus, it is not clear at all what will happen to product quality when voice-strong people do exit. This means that the quality-argument against freedom of choice, in defence of public monopolies, is not a strong one.

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choice is restrained when there is an unambiguous reduction in the size of the opportunity set (page 11).

It may also be hypothesized that the individual believes that his freedom of choice is reduced when options outside the budget set are removed by government actions. For instance, in the context of figure 2, the individual may feel that his freedom of choice is damaged if the government forbids the consumption of all bundles either in area X or in area Y -- X being a bundle that he would consider consuming at somewhat different income or relative price, and Y a bundle that he regards as being completely outside his range (forever). We may say that freedom of choice in society at large is reduced -- in the first case for the individual itself in an alternative, quite realistic situation, and in the second case for other individuals.

The notion that options beyond the reach or interest of the individual contribute to his freedom and welfare is not unknown in the literature of philosophy and fiction, from Aristotle, via Kirkegaard and Dostojevskij to modern existentialism. Similar interpretations of the concept of freedom of choice are also found in the literature on economic geography and spatial (urban and rural) planning -- often in connection with the concept of "accessibility"; the individual is assumed to value the existence of theater and opera in his community even if he plans never to attend a performance.²⁰ In a similar way, the individual may be anxious to keep a national park unexploited, even if he intend never to visit it.

One conceivable way of formalizing the importance of "apparently irrelevant alternatives", like X and Y in figure 2, is to let the

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20 For a short survey, and a development of mathematical concept of accessibility, see J.W. Weibull (1980) 53-67.

utility function includes the entire set of options, in society, not only those that are inside but also those that are outside the actual opportunity set -- beside the actually chosen consumption vector. In terms of figure 2, the entire product space would be an argument in the preference function -- beside the actually obtained bundle. Of course, we are then encountered with the same problems of measurement as in the context of the earlier discussed evaluations of entire opportunity sets (p.11).

In the example in figure 2, it was assumed that certain quantities of existing goods are not allowed (bundles X or Y). A more important case is perhaps that certain products, or product varieties, are entirely removed from the market. To make justice to this idea, it is, again, necessary to shift to a multidimensional representation. The elimination of certain products or product varieties, also outside the opportunity set of the individual, would then be depicted as the elimination of one or several dimensions in the product space.

An analytical representation more in line with traditional theory is to assume that the individual is uncertain about his budget equation, and/or his preference function, in future periods. In the context of such a stochastic approach, which catches at least some aspects of the importance to the individual of a set like X, bundles southwest of point a, in figure 2, or product varieties outside the budget set, we would assume that the individual maximizes expected utility, with expected life-time wealth as budget restriction. The importance of the set Y for the individual, too, may be considered in the context of traditional utility theory if we assume that the individual is altruistic, in the sense that he wants others, including perhaps his own children (or grandchildren) to satisfy their preferences without government

intervention. Thus, traditional theory can certainly cope with at least some aspects of the issue of the removal of "apparently irrelevant alternatives".

(ii) Predictability of outcome of choice

However, when analyzing the relations between welfare state policy and individual freedom, another type of uncertainty is probably more important, namely government-induced limitations on the predictability of the consequences of individual choice. In general, for freedom of choice to make much sense it must be possible to act purposively, which in turn requires that the individual can predict the consequences of his actions with a reasonable degree of certainty. Freedom of choice is meaningful only if there is a certain stability and predictability of the pay-off matrices for individual agents. A society with far-reaching government intervention, with laws and regulations changing all the time, tends to damage this predictability.

An important explanation for the tendency of governments to make the pay-off matrices less stable is that politicians seem to be more interested in the outcomes in individual cases than in the stability of the rules of the game. Moreover, there is in such societies often a tendency to introduce new legislation in order to control "everybody" in a certain population category, or profession, as soon as "somebody" in that category is asserted to have "misbehaved" -- either by braking the law or simply behaving contrary to the intent of the law.

More specifically, when individuals adjust their behavior to government policies in ways which the government does not like, the government takes counter-measures which the individual cannot predict very well. Two types of countermeasures of the government seem to be

particularly relevant and prevalent. First, in order to counteract unexpected and undesired effects of previous policy interventions, politicians make new interventions -- seemingly in an endless stream of new laws and regulations. The result is rule instability. Second, as individuals adjust to new rules and regulations in ways which politicians do not like, these are tempted to make the rules more vague, to make it possible for the authorities to interpret the rules more freely, and hence to make it more difficult for individuals to escape the intended effects of the policy interventions. As a result, the rules of the game will not only be more unstable, but also less known at every point in time. As a consequence of both these reactions of the government, the economic system tends to become a complicated "tax-, benefit-, and regulation lottery", with quite unpredictable effects on the distribution of wealth and economic welfare.

All this means that decisions which yesterday seemed rational to the individual, under the rules that existed then, may turn out to have been mistakes either because politicians have changed the rules overnight, or because there is a new interpretation of the existing rules -- obvious examples being the frequent changes and reinterpretations of the rules of the taxation of various types of assets, as well as various rules and regulations concerning the operations of government service institutions, including the priority ordering in public queues for housing and municipal day-care centers, old age centers and institutions of higher education. (Clearly, those effects can largely be analyzed by traditional economic analysis, provided government-implemented uncertainty is introduced into the "pay-off function" for individual actions.)

One important effect of all this is that ambitions of welfare

state policies to increase economic security, after some point, may be counter-productive, as increased political and administrative risks tend to replace the market risks which the government initially tried to reduce; the stochastic elements in the "pay-off function" of individual action may then increase over time, rather than fall as intended. This damage to the predictability of the consequences of individual choice may clearly be characterized as a reduction in individual freedom.²¹

Indeed, a society of this type tend to drift away from "rule by law" to "rule by discretion", both by exposing private agents to arbitrary changes in the laws, and by giving public officials considerable discretionary powers to interpret the laws. The Kantian "Rechtstat" is then clearly threatened, even though democratic institutions and political freedom are intact. An extreme example is the so called "general clauses", used for instance in Sweden today, whereby formally legal actions by individuals or private organizations may be declared invalid by the court if the actions are regarded by the courts as not being in conformity with the intent of some legislation.

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21 James Buchanan has described the situation in the following graphical terms for the US, where this problem most likely is much less serious than in some of the more "advanced" welfare states in northwestern Europe: "Descriptively, we live in what might be called 'constitutional anarchy' where the range and extent of federal influence over individual behavior depends largely on the accidental preferences of politicians in judicial, legislative and executive position of power. Increasingly, man finds himself at the mercy of a faceless, irresponsible bureaucracy, subject to unpredictable twists and turns that destroy and distort personal expectations with little opportunity for redress or retribution" (Buchanan, 1975, p.4.)

(iii) Individual privacy and integrity

This discussion takes us to our final point, namely, the consequences of welfare state policies for individual privacy and integrity. By "privacy" I mean the right of the individual to withhold information about its life to others, while "integrity" refers to the right of the individual to avoid far-reaching intervention in its life by others, including by the political authorities.

When discussing this issue, it is first of all important to note that general support systems, like negative income tax systems and social security systems, require less scrutiny of individuals than do selective support systems. Thus, the former systems, taken by themselves, are more favorable than the latter for privacy and integrity, even though general support systems tend to create higher levels of public spending than do selective systems. This illustrates the inadequacy of assuming that individual freedom necessarily falls by higher levels of public spending; we have to look also at the types of spending and its financing. However, if more and more benefit systems are introduced, and if these become more and more generous, and the marginal tax rates higher, the gains in terms of privacy and integrity of general, as compared to selective support systems, will be counteracted, and even lost by the need to build up public information and control systems to fight tax and benefits cheating.

A basic reason why privacy is threatened by far-reaching welfare state policy, even when quite general systems are used, is that such policies, if they include high marginal tax and transfer rates, may make honesty towards the state quite "expensive" for the individual because of the gains from giving incorrect information in connection to taxes and public benefits. And when honesty becomes expensive, there will be

less of it. The government will therefore be induced to build up an elaborate system of information of the lives of individuals and private organizations.

For instance, in a dishonest society, the government has to check that people who receive unemployment benefits or sick leave compensation do not, in fact, work somewhere, such as in the "underground economy"; and that people who are paid by the government for staying home to take care of sick children or other relatives are doing just that rather than enjoying paid leisure. The authorities may also want to investigate whether unmarried mothers with public benefits really live alone, for instance by asking them how many nights a man stays over in their home. Some citizens, in particular if they have rather low (declared) incomes, may also be asked by the tax authorities to explain the sources of some of their spending, such as their recent vacation trip abroad, etc..

Moreover, by imposing taxes, such as value added taxes, on most economic transactions between private agents, the government will be able to get some "double check" on transactions in the private sector, with data both from sellers and buyers, which simplifies control of individual transactions drastically. To get an additional double check the government may require private individuals to report parts of their spending to the authorities, such as the purchases of services from craftsmen. To fight false reporting, the authorities may also make private firms financially responsible for the lack of tax compliance among other firms, which they make business with.

These examples are no fantasies; questions such as these are already a fact of life in my own country, Sweden. Moreover, information about practically all economic relations and transactions in Sweden between the individual and the public sector tend to be collected in

numerous, in fact over one hundred, government data systems -- a procedure that is highly facilitated by the requirement that ID-numbers of citizens be provided in all transactions with public authorities. This makes it possible for the government to check whether the individual has given consistent information about his economic situation, and life situation in general, to different public agencies, such as the tax authorities, public hospitals, public care centers, various segments of the social security systems and various public agents that provide subsidies and permits of different kinds.

A problem with these various arrangements, from the point of view of individual privacy, is that information about the private life of individual citizens will be spread out over the public administration, and also "leak" to various public officials and other citizens. Single pieces of information which are "innocent" in isolation may damage the reputation of an individual when hundreds of such pieces of information are combined. There is also a risk that politicians in government positions, and their supporters in the administration, may try to leak "negative" information to mass media and to the general public about the private lives of political opponents or their relatives.

However, not only privacy but also integrity is threatened. If the individual is not willing and able to exploit various loopholes in the tax or benefits system, his best chance to improve his economic situation will often be to adjust his life to the desires of public authorities, hoping to get increased benefits from the government. The individual will then, to a considerable extent, be induced to consume just the goods and services that the government is willing to provide and subsidize, and to accept the division of labor between the household, the market and the public sector -- and indeed also within

the household -- that the government prefers. In extreme cases, we may wind up in a "public benefit" and "pocket-money" society, where the amount of the provided services and pocket money, to a considerable extent, depends on the willingness and ability of the individual to adjust its life to the desires and signals of public authorities.

Extensive and strongly interventionist regulations, outside the narrow field of welfare state policy, have similar consequences. For instance, offences against rent controls would, of course, not exist without such controls, nor would offences against building regulations exist without government restrictions on building activity. Similarly, exchange control offences would not exist without regulations of foreign exchange markets, nor violations of price controls without price regulations, or smuggling without tariffs and other trade restrictions.

Anecdotes about particular interventions and particular countries aside, the point is that the higher the marginal tax rates, and the greater the public benefits available, and the more regulations there are around, the stronger will be the incentives for citizens to cheat, and the stronger will be the temptation for the authorities to build up elaborate information and intervention systems, which is bound to reduce the privacy and integrity of the individual. All this means that an advanced welfare state, with high marginal tax and transfer rates, would, after a while, be expected to result also in an elaborate control state. In fact, it is typical for advanced welfare states that the government feels forced to use more and more of its legal and police resources to fight "crimes against the state" rather than "crimes against individuals". As a result, the state may then not even have enough police and legal resources to protect individuals against "the

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tyranny of anarchy", even though such protection was initially a basic rationale for having a state.

Thus, not only will the government indirectly, via government-imposed incentives, drastically influence what the individual does, and prevent him from doing what he wants. The lives of individuals will also grow ever more closely investigated and directed by decretionary, individual-specific interventions. "Individual freedom" will be threatened in the sense that citizens are prevented from enjoying two very important private goods, namely privacy and integrity. Analytically, we may indeed treat this kind of loss of individual freedom as a shrinkage of a generalized opportunity set of the individual.

Of course, there is an alternative to a control state, namely to accept slack in the system, in the sense that a considerable amount of cheating with taxes, breaking of regulations and misuse of benefits are accepted by the authorities, in order to avoid tight control of individuals. Obviously, democratic societies tend to opt for some combination of control and slack.

A summing up

The traditional utilitarian argument in economic analysis for individual freedom, including freedom of choice, is "consequentialist", or "instrumentalist", in the special sense that decentralized decision-making is defended by its consequences for economic efficiency in production and consumption, and hence also for the actual consumption bundles of individuals. This argument is a strong one, as knowledge of individual preferences and production processes are "contained" in

millions of individual heads, and cannot be transmitted to some centralized decisionmaker (a point which has been particularly developed by Friedrich von Hayek). However, this lecture has argued that the individual may be interested also in the process by which a certain consumption bundle is achieved, and that indeed the individual values the act of choosing as such, which means that freedom of choice also has an "intrinsic" value.²²

These considerations imply, of course, that public intervention cannot be evaluated only on the basis of their consequences for the bundle of goods and services which the individual actually consumes. In the context of the analysis that has been pursued in this lecture, it will be necessary to consider also (1) difficulties for the individual of influencing his economic situation by his own effort; (2) "frustration effects", in addition to traditionally defined utility losses, in the case of binding non-budgetary restrictions on individual behavior; (3) the removal of "apparently irrelevant alternatives"; (4) reduced predictability of the consequences of individual choice; and (5) losses in privacy and integrity of the individual in connection to the build up of a control state as a complement to the welfare state. If these effects are taken seriously, it is clear that conventional cost-benefit analyses of the effects of public interventions -- in the form of taxes,

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²² Of course, when there are externalities, utilitarianism may conflict with the quest for decentralized decision-making, and hence with the quest for freedom of choice and the desire of a "private sphere" for the individual. Indeed, this seems to be the background for Amartya Sen's theorem of "the impossibility of a Paretian Liberal" (Sen, 1970), as this theorem is derived from the assumption that outsiders' preferences concerning "the private sphere" of an individual should count in the paretian calculation.

It is also obvious that while a utilitarian position is quite consistent with government paternalism, when the individual is assumed not to act in accord with his own best interest in the view of the utilitarian observer, paternalism is clearly in conflict with the liberal notion that freedom of choice is a value in itself.

~~spending programs and regulations, including welfare state programs --~~
may have to be considerably modified.

All this means that the most severe problems in advanced, high-income welfare states, in addition to productivity losses in connection to economic disincentives, probably show up in the form of psychological effects. This is not the right occasion -- or the right speaker for that matter -- to penetrate the character of such psychological effects. However, modern psychology concerning so called "learned helplessness" (Magnusson (1980)) reports, on the basis of experimental evidence, that individuals who learn that they cannot influence their own situation in life by their own effort tend to become either passive, or aggressive towards those who restrict their behavior. In the first case the individual expects somebody else, such as the government, to take care of them, i.e., "passivity" and "dependency"; in the second case they try to break the rules of the system that denies them the rights to control their own life situation, i.e., "cheaters" or "revolutionaries".²³

There has for a long time been a strong tendency among intellectuals in the west to be much more worried about direct government intervention in intellectual or political freedom, such as freedom of speech and expression in general, than about limitations in the "economic freedom" of the individual. Indeed, the latter type of intervention is often, as Joseph Schumpeter (1950) once argued, applauded by these persons. Perhaps this is natural for intellectuals, who certainly are particularly active in "the market of expression",

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²³ Several moral philosophers have argued that the freedom to choose also makes an individual "a better human being", e.g. (Mill 1975, chapt. 3); (Hayek 1960); and (Nozik 1974).

Maybe it could also be argued that increased "passivity" of individuals, who have learnt that the government decides for them, will raise the psychological costs of deciding by themselves.

rather than in traditional goods and asset markets. However, it is far from selfevident that other citizens regard restrictions that reduce the freedom to choose their consumption bundle, and to change their economic situation in general by their own effort, as necessarily being less important than freedom of speech and artistic expression. Such intellectuals often also seem to forget that limitations in the freedom of choice in the economic field, as we have seen, generates limitation on other types of freedom as well, such as privacy and integrity.

Moreover, if tax policy results in a drastic reduction in the number of large and moderate-sized private wealth holdings, we would expect not only private firms but also various types of non-profit institutions to become strongly dependent on government funds, as the availability of both private equity capital and private donations can be expected to be rather small in such a society. The most obvious effect for an economist is perhaps that centralized, politically controlled supply of capital is likely to harm the chances of the survival of decentralized entrepreneurship. However, if the public sector becomes the dominant financier of research and culture, there is also an obvious risk that pluralism in these fields will suffer, as researchers and artists, as well as administrators of institutions of research and culture, like people in general, may hesitate to "bite the hands that feed them".

However, to avoid one-sidedness in the analysis, it is important to remind ourselves, again, that certain kinds of government policies, including parts of welfare state policies, may expand, rather than reduce individual freedom, at least for some citizens. I am referring not only to the earlier mentioned observations that government-guaranteed property rights and transaction rights are crucial for the

protection of the individual against "the tyranny of anarchy"; that freedom of choice will increase for people who gain wealth by way of redistribution policies; and that general social security systems may be more favorable for privacy and integrity than are "smaller" welfare-programs that are highly selective in the sense of requiring individual applications and bureaucratic scrutinizing of applicants. It may also be argued that compulsory social security systems, by removing market imperfections, may create opportunities, in the form of insurance programs, that did not exist before -- though the compulsory character of such systems, by themselves certainly implies a limitation on the freedom of choice for some people. Another example is policy actions that increase social mobility, such as free education and government guaranteed loans to students, which may create opportunities that would not exist otherwise, as many individuals do not have either enough wealth to finance their studies, or sufficient access to the capital market because of the difficulty of using expected future human capital as collateral for borrowing. An additional example of a government action, outside the area of conventional welfare state policy, that may increase the freedom of choice of the individual is environmental policies, by way of tax-subsidy programs or regulations. As such policies may disentangle "fixed combinations" of production and pollution, the menu of choice for citizens may be widened.

Moreover, conceivable damage to individual freedom that stems from welfare state policies should, of course, be compared with various types of gains in other respects, such as those briefly mentioned in the beginning of the lecture in fields like economic security and the distribution of wealth. Indeed, these gains may in many cases, by a majority of citizens, be regarded as dominating the disadvantage of the

losses in individual freedom. Thus, it is likely that much of the paternalism that is implied in various welfare state policies is basically accepted by a majority of the population, as a reasonable trade-off between individual freedom and economic security. However, the purpose of this lecture has not been to analyze various trade-offs between achievements of welfare states policies and conceivable "net" losses in individual freedom; the theme of the lecture has been the consequences just for individual freedom.

For these various reasons, there is no contradiction in applauding the build-up of a welfare state up to a certain point, but to be worried about what happens when this point is surpassed. In other words, the issue is not whether the welfare state "as such" has served its citizens well or not, or if it has increased or reduced individual freedom, but rather if and when (from the point of view of certain subjective values) one surpasses the point at which the detrimental effects, including various freedom-reducing consequences, start to dominate various beneficial contributions of additional welfare state policy actions.

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