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Economic Freedom: A Hayekian Conceptualization[i]

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Abstract: In this paper, we develop a conceptual framework for an understanding of economic freedom based on Hayek (1960), and, as a step further we propose a categorization of government actions, which allows us to conceptualize the measurement of economic freedom in a different way from that of the indexes of economic freedom. This method of proceeding, that is "theoretical framework first, and measurement after, if possible" differs from the one adopted by those who have constructed the indexes of economic freedom. An advantage of our concept of economic freedom is that it is compatible with a theory of growth, and this being so, it provides additional insights to a better understanding of how economic freedom leads to growth.

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1 Introduction

During the past decade the concept of economic freedom, after being for a relatively long period a subject of little interest among economists, has attracted more attention. This is due to the emergence of indexes ranking countries according to a scale running from the least free to the freest. Now there exist two widely accepted indexes of economic freedom: the one developed by the Fraser Institute (Economic Freedom of the World Index, EFW index), and another constructed by the Heritage Foundation jointly with the Wall Street Journal (Index of Economic Freedom). These two indexes are quite similar in terms of what they consider as a plus and as a minus when measuring economic freedom.

The Fraser Institute was the first to construct an index of economic freedom and publish reports on a regular basis. The roots of the index published in *Economic Freedom of the World* go back to a series of conferences hosted by the Fraser Institute and Nobel laureate Milton Friedman from 1986 to 1994. These conferences focused on measuring how consistent a nation's institutions and policies were with economic freedom. These conferences led to the publication, in 1996, of *Economic Freedom of the World: 1975–1995* (Gwartney et al. 1996), in which the EFW index itself was developed.

The whole of Fraser's project has been very ambitious and, of course, important, and it has fulfilled what it projected. Compared to the initial index, the current version (Gwartney and Lawson 2007) is more comprehensive, ratings are available for more countries, and the chain-link version of the index provides for more accurate comparisons across time periods. Clearly, data provided by the Fraser Institute's reports has led to a significant number of econometric studies on how economic freedom affects income and various measures of human welfare.

However, since the explicit aim of the Fraser Institute was to measure economic freedom, this determined the way the concept of economic freedom was formulated: the conceptualization has been largely driven by empirical (measurement) considerations. As Block (2006), one of the fathers of the index, explains, an empirical measurement of economic freedom requires an operational and empirical definition of economic freedom. The former means that "economic freedom is defined solely in terms of an amalgamation of the empirical indices that together comprise it" (Block 2006, p. 481). The latter refers to the fact that the concept must be quantified, i.e. it is based on statistics.

Clearly, both requirements vis-à-vis the concept of economic freedom are apparent in the definition given by Fraser's scholars (Gwartney and Lawson 2007, p. 3): "The cornerstones of economic freedom are personal choice, voluntary exchange, freedom to compete, and security of privately owned property." In this spirit, the Fraser's index includes five main areas, each broken down into several components and subcomponents, all quantifiable. The areas are as follows: (1) size of government: expenditures, taxes, and enterprises, (2) legal structure and security of property rights, (3) access to sound money, (4) freedom to trade internationally, (5) Regulation of credit, labor, and business.

The operational and empirical character of the conceptualization of economic freedom is taken even more seriously in the case of the Heritage Foundation's index which explicitly considers economic freedom as a composite concept encompassing various kinds of economic freedom (Kane, Holmes, and O'Grady 2007). These are business freedom, trade freedom, monetary freedom, freedom from government, fiscal freedom, property rights, investment freedom, financial freedom, freedom from corruption, and labor freedom.

As opposed to the above method of conceptualizing economic freedom, namely one driven by operational and empirical considerations, we believe that economic freedom is a concept in its own right, and this being the case, a theoretical framework is first needed for a full understanding of the concept. Subsequently, whether this theoretically-based concept may or may not be measurable is another question. Thus, we propose to reverse the direction in which the Fraser Institute and the Heritage Foundation proceed: theoretical framework first and measurement after if possible.

Thus, the aim of this paper is to contribute to the development of a theoretical framework for an understanding of economic freedom. In this endeavor, we will argue for the usefulness of the Hayekian notion of freedom, which can serve as a crucial concept upon which such a framework can be built. Trying to formulate Hayek's ideas on a less abstract level, we propose a categorization of government actions, which gives us some guidance concerning which government actions hurt and which do not hurt economic freedom. An advantage of this categorization schema, as we show, lies not only in the fact that it can be operationalized – that is, measured – but also in the fact that it can point to a mechanism through which economic freedom may affect income – a mechanism that is excluded when using the above-mentioned two indexes, and consequently which does not appear as an explaining factor in the empirical literature on economic freedom dealing with how economic freedom affects growth.

The paper is organized as follows. In Section 2, we provide and argue for the usefulness of a concept of economic freedom based on Hayek (1960), the rule of law being a core element of this concept. In Section 3, we develop a classification of government actions based on this concept. Section 4, discusses the relevance and empirical usefulness of our conceptual framework of economic freedom based on the categorization of governmental actions. Section 5 concludes.

2 The Usefulness of the Hayekian Concept of Freedom

Hayek developed his concept of freedom in *The Constitution of Liberty*. In what follows we present the Hayekian concept of freedom, whose usefulness consists in the generality of the concept, which, accordingly, can be applied to conceptualize various kinds of freedoms, such as economic, political or civil freedom.[1] Focusing, of course, on economic freedom and relying on Hayek (1960), we show that a core element of economic freedom is the rule of law.[2] As a starting point, we must bear in mind that the concept of economic freedom like other kinds of freedom is related to individuals, and accordingly, it should be interpreted in terms of individuals' actions.

We think, however, it is necessary to make a clarification before trying to conceptualize economic freedom. Since the state is inevitable (Holcombe 2004, Benson 1999, Olson 1993, 2000),[3] our argument is that economic freedom should be inter-

[1] We agree with Friedman (1962) in seeing economic and political freedom as components of freedom broadly understood, so both being ends in themselves.

[2] We argue that additional elements such as freedom of contract, property rights, sound money and political decentralization which were emphasized by Harper (2003) as constituting parts of economic freedom come from and depend on it. Because of a shortage of space we cannot develop this idea here.

[3] For a critique see Leeson and Stringham (2005).

preted under the existence of a state (government). To put it differently, in accordance with Hayek (1960), economic freedom should be understood as freedom under governmental law and not the absence of all governmental actions. Thus, economic freedom does not mean freedom in an absolute sense; some governmental actions must be supposed to exist. The reason for this lies in how the state has emerged in an undesigned, evolutionary process (Barzel 2000, 2002, Benson 1998, 1999, Hayek 1973, Holcombe 2004, Olson 1993): all modern states evolved from extortionist institutions to secure property rights. And in this evolutionary process the state acquired a monopoly over coercion.

Consequently, coercion[4] is a crucial concept for making sense of freedom. History shows that institutionalized coercion by private (nongovernmental) parties is almost never tolerated, but we tolerate governmental coercion (Klein 2007). Why do we tolerate infringements of property and liberty rights by the government? The answer is that the coercive power of the state is useful when it protects our lives and property from outside (private) coercion:[5] "[f]reedom demands no more than that [the coercion of other individuals'] coercion and violence, fraud and deception, be prevented, except for the use of coercion by the government for the sole purpose of enforcing known rules intended to secure the best conditions under which the individual may give his activities a coherent, rational pattern" (Hayek 1960, p. 144).

To sum up, not all kinds of coercive governmental actions are to be condemned; instead it is in our interest to tolerate some kinds of coercion. However, bear in mind that the state, by having a monopoly over coercion, remains the primary threat to freedom. Accordingly, the major question is in which field(s) government monopoly over coercion is allowed and what kinds of governmental actions are not harmful to (economic) freedom. Clearly, not all means are appropriate in order to assure the

[4] "Coercion occurs when one man's actions are made to serve another man's will, not for his own but for other's purpose" (Hayek 1960, p. 133). The coercer can determine the alternatives for the coerced so that the latter will choose what the coercer wants: "in order to avoid greater evil, he [the coerced] is forced to act not according to a coherent plan of his own, but to serve the ends of another [the coercer]" (Hayek 1960, p. 21).
Of course, there are several forms of coercion. The threat of violence or physical force is the most important form of this, and even in this form there are many degrees of coercion.

[5] As Hayek (1960) argued, a paradox is that the only means whereby the state can prevent the coercion of one individual by another is the very threat of coercion, i.e. the only way to prevent one coercion is by the threat of another one.

greatest possible freedom. The only acceptable means, as argued by Hayek in the above quotation, is enforcing known rules.[6] This implies that economic freedom relates to the character, rather than the size of government actions, which, in turn, relates to the issue of efficiency, and these two do not necessarily overlap.[7]

Although Hayek (1960, 1973) does not differentiate between various types of freedom, such as political or economic freedom, his concept still provides a coherent basis for making sense of economic freedom. We argue that the adjective "economic" or "political" determines the fields in which we should narrow or specify the meaning of freedom, understood broadly as absence of coercion except for state coercion, to enforce known rules. In this spirit, when it comes to economic freedom, state monopoly over coercion should be understood as concerning the economic activities of individuals, more precisely their entrepreneurial acts. Economic freedom permits individuals to exploit their productive potential by following their own plans and the opportunities to amass wealth safeguarded against confiscation (Barzel 2000). That is, in an economically free society individuals are allowed to realize their plans on the market. If state coercion goes beyond the limits defined above, economic freedom is hurt. Accordingly, state coercion must be limited. Normative restrictions should be imposed on the coercive power of the government and on the manner in which it exercises its power (Hayek 1960).

The principle that provides us with a criterion according to which we can evaluate freedom is the rule of law.[8] This *ideal* of freedom is best described in Hayek (1960) and in Leoni (1961), and refers to a situation where governmental coercive actions conform to general abstract rules laid down beforehand. In fact, the rule of law is a

[6] Friedman (1962, p. 15) also supports this view: "...government is essential both as a forum for determining the 'rules of the game' and as an umpire to interpret and enforce the rules decided upon."

[7] This implies that, as opposed to what is suggested in a large part of the literature, the concept of "limited government" should not refer to the size of the government *per se*, but rather, to in what fields the state exercises its coercive power. It is worth noting that this serious confusion of two economic criteria, namely economic freedom and efficiency in the literature (among others Carlsson and Lundström 2002, Dawson 1998, 2003, De Haan and Siermann 1998, De Haan and Sturm 2000, Grubel 1998, Gwartney et al. 2004, 2006, Scully 2002, for an overview of the literature see Doucouliagos and Ulubasoglu 2006) is the result of a lack of a coherent understanding of the way economic freedom affects growth.

[8] "Nothing distinguishes more clearly conditions in a free country from those in a country under arbitrary government than the observance in the former of the great principles known as the Rule of Law" (Hayek 1944[1971], p. 54).

doctrine of what the law should be: "The rule of law is therefore not a rule of the law, but a rule concerning what the law ought to be, a meta-legal doctrine or a political ideal" (Hayek 1960, p. 206). Clearly, the rule of law restricts government in its coercive activities.[9]

The rule of law includes three principles: (1) the certainty, (2) the generality and (3) the equality of the law. The certainty of law is probably the most important requirement for economic activities; according to Leoni (1961, p. 95) it refers to the fact that individuals can make long-term plans, which necessitates that the law is not subjected to sudden and unpredictable changes.[10] The generality of law means that the law never concerns particular individuals, i.e. law is abstract from the specific circumstances of time and place.[11] In other words, to be abstract the law must consist of purpose-independent rules governing the conduct of individuals towards each other and apply to an unknown number of further instances by enabling an order of actions (Hayek 1973). Equality of the law means that all legal rules apply to everybody including to those in power. That is, every individual, whatever his rank, is subject to the ordinary law of the realm. More importantly, laws apply both to those who lay them down and those who apply them. As a result, the state is limited in the same manner as any private person.

In addition to these three principles, as Leoni (1961) proposes, we should add another one, although Hayek (1960) does not qualify it as a principle. This is the fact that administrative discretion in coercive power must always be subject to review by independent courts. What is required under the rule of law is that a court should have the power to decide not only whether a particular action of the government agency was *intra vires* or *ultra vires* but whether the substance of the administrative decision was as the law demanded (Hayek 1960, p. 214). To ensure this there must be some authority which is concerned with the rules, and not with any temporary aims

[9] Note, however, that the rule of law is concerned *only* with the coercive activities of the government. It limits the functions of governments to those that can be carried out by means of general rules, but it does not tell anything as regards the non-coercive activities of the government.

[10] As Leoni (1961) argues, as opposed to this Anglo-Saxon concept of the certainty of law, the Continental idea of the certainty of the law was equivalent to the idea of a precisely worded, written formula. Note, however, that this does not guarantee that individuals would be free from interference by authorities.

[11] British common law is this type of an abstract law, evolved in a spontaneous process. For an overview of its emergence and evolution see, among others, Benson (1998).

of the government, and which has the right to say whether another authority had the right to act as it did, and whether what it did was required by the law.

As stems from the above, the rule of law is an indispensable institution for freedom. As Voigt states, "individual liberty is impossible without the rule of law" (1998, p. 196).[12] We also consider the rule of law a core element in economic freedom since it is this principle that gives us guidance to determine what kinds of actions the government can take in an economically free country.[13] When it comes to economic freedom, as already said, it should be possible for individuals to base their entrepreneurial actions on their own individual plans. If laws conform to the above three (four) principles, then individuals are able to form plans based on their knowledge since laws are data for them, which can be accounted for.[14]

However, the usefulness of the Hayekian concept of freedom understood as absence of coercion except for state coercion to enforce known general rules lies not only in the fact that it is a general concept, and as such can be applied to various kinds of freedom, but also in that it can be operationalized by relying on a single concept, namely that of the character of governmental actions. Below, following the Hayekian line but going a step further, we develop a categorization of government actions on which our theoretical framework for an understanding of economic freedom is based.

3 Economic Freedom and Government Actions: Towards a Clarification

A conclusion from the above is that economic freedom relates to the character of government actions, rather than the volume of government actions. In this respect, we think it is useful to distinguish, on the one hand, between coercive and non-

[12] However, as explained by Cass (2003), we should bear in mind that the rule of law does not assure that laws are wise or just or whatever because the human mind has not been able to devise only wise things. The focus of the rule of law is to assure law-bounded qualities.

[13] We note in accordance with Voigt (1998) that a perfect rule of law has never been realized. Therefore, in what follows, we will refer to this hypothetical perfect state of rule of law as the *ideal* of the rule of law, which will serve as a criterion for reference when taking into account those phenomena which reduce economic freedom.

[14] The rule of law consists of "rules fixed and announced beforehand – rules which make it possible to foresee with fair certainty how the authority will use its coercive power in given circumstances, and to plan one's individual affairs on the basis of this knowledge" (Hayek 1944[1971], p. 54).

coercive actions, as we have implicitly done above, and on the other hand, between two kinds of coercive activities of a state: those that are compatible with economic freedom (freedom-compatible coercive activities) and those that are not (freedom non-compatible coercive activities). In what follows we characterize government actions at a greater length in this categorization schema.

3.1 Non-Coercive Activities

Non-coercive government activities, referred to as "services" by Hayek (1960, 1973), by definition, do not concern economic freedom, while they influence the size of the government. On the one hand, there are those services that the government should exclusively provide; that is, it should have a monopoly (services with agreed monopoly). On the other hand, there are those in which, in principle, the government should not have a monopoly (services provided on competitive grounds).

The former set of services includes those government actions that are imperative for a favorable institutional framework for individuals' free acts. Since the institutions in question would not emerge spontaneously, i.e. they need governmental design, the government should have a monopoly over them. Clearly, these services (e.g. various official governmental statistics and information) provide the means for a better execution of individuals' plans.[15]

As far as the second group of services is concerned, here the government is only one of the (many) providers of goods and services and should work on the same terms as individuals. These services may include most importantly various health care services and schooling.[16] However, note that these kinds of non-coercive activities are almost absent or at least very rare since government usually maintains its monopoly, that is, they are not provided on competitive grounds.

[15] We note that the services with agreed monopoly do not coincide with public goods, most importantly because public goods include coercive activities, too. But we think that the crucial problem is that the notion itself is dubious because the criterion economists use to qualify a good as a public good is arbitrary, and reflect beliefs rather than objective measures: the criterion of excludability is only a matter of cost, and accordingly, a matter of degree. See Block (1983).

[16] A good example would be the education voucher system as proposed by Friedman and Friedman (1990).

Of course, nothing guarantees that the government provides these services in an efficient way. However, the important thing is that one should not confuse the issue of economic freedom with that of efficiency. Even the fact that there is an efficiency loss under government provision of these services has nothing to do with economic freedom. Of course, we do think that efficiency loss has to be seen as an argument against the government, but this is an argument in its own right, which is different from arguing against the government on the grounds of economic freedom.

Clearly, this question should not be confused with the question of what method the government adopts to provide these services. Not all methods are acceptable when it comes to economic freedom. For instance monopoly, prohibition, or specific orders are not. In a free society the government can have the monopoly only over coercion, and nothing else, and in other respects it has to operate on the same terms as everybody else (Hayek 1960, pp. 222-223).

In Table 1, we summarize non-coercive government activities.

Table 1: Non-coercive governmental activities
Services with agreed monopoly Services that provide a favorable framework for individuals' decisions (monetary system, statistics, etc.)
Services provided on competitive grounds Services that are provided both by the government and by private firms on the same terms (e.g. schooling, health care, etc.)

A conclusion from the above is that while non-coercive government activities do not hurt economic freedom, they have an impact on the size of the government. In principle, one can imagine such a country where, for instance, many competitive services are provided by the government because people prefer these to those provided by private firms, causing big government, but despite this fact economic freedom is not hurt. In this respect note that up to a certain point the quality of the services with agreed monopoly also depends on financial resources devoted to them: the bigger the government the better the quality of these services. This also supports that there is no direct relationship between the size of the government and economic freedom.

To summarize, both services with agreed monopolies and competitive services can and must be analyzed according to the criterion of efficiency. It may be that there are significant efficiency losses as regards these government actions, which is, of course, an argument against the government actions or in favor of small government. But bear in mind that this argument is not based on economic freedom grounds, but rather, efficiency grounds, which is a different thing.

3.2 Coercive Activities

As regards the coercive activities of a state, we propose to differentiate between freedom-compatible and freedom-non-compatible coercive activities. The former, being predictable, are compatible with the functioning of the market because they allow individuals to make plans and realize them on the market. The essential thing is that these government activities can be accounted for. Opposed to these, non predictable or arbitrary activities make individuals' planning impossible or at least largely uncertain. They are non-compatible with a free market.

Freedom-compatible coercive activities do not hurt economic freedom, provided they conform to the *ideal* of the rule of law. However, as implicitly suggested above, any deviation from the *ideal* reduces economic freedom. Clearly, this issue is related to the quality of the rule of law. Furthermore, one can evaluate freedom-compatible activities according to further criteria such as efficiency.[17] As far as freedom-non-compatible coercive activities are concerned, they reduce economic freedom *per se*; they must be rejected solely on the basis of freedom non-compatibility, and the efficiency criterion does not come into play at all.

A crucial question is thus how to separate those coercive activities that are the pre-conditions for freedom from those that harm it. On a conceptual level, one can apply Vanberg's (2001) constitutional choice argument as a criterion for what is "laid down beforehand." Given that a constitutional choice means an agreement "on rules," the process of this choice defines whether the coercive activities of the government fit the *ideal* of the rule of law. The question to be answered in this case is whether

[17] It is worth noting that Hayek himself talks about "expediency," a concept which is not clearly defined and seems to include such additional criteria as fairness, or justice, or efficiency. Instead of expediency we adhere to the term "efficiency" for reasons developed in Colombatto (2007).

a particular coercive activity of the government passes the test of voluntariness on a constitutional level. Although the practical meaning of voluntariness of the choice of rules is dubious, it is a good conceptual tool for deciding whether a certain government regulation harms economic freedom or not.

Having made these rather general remarks, let us analyze the coercive activities of the government in more detail. Freedom-compatible activities include, on the one hand, those activities that are necessary implications of the monopoly over coercion such as the enforcement of contracts, the security of property rights, or national security.[18] There is no doubt that, for instance, ensuring the security of property rights, while being a coercive activity, does not harm freedom; on the contrary, it is necessary for the rule of law.

In addition to the above activities, there are those general regulations that are laid down in the form of rules specifying a certain type of activity, conforming ideally to the principle of the rule of law. These regulations may concern, for instance, the techniques of production by limiting the scope of experimentation, or by prohibiting some activities for reasons of health, or by permitting other activities only when certain precautions are taken, and so forth. Clearly, these regulations raise the cost of production and reduce productivity, but they do so equally for all who engage in the particular production activity and can be taken into account when making plans. Note that, of course, these regulations must be analyzed according to the criterion of efficiency.[19]

As opposed to these freedom-compatible regulations there are those that are not compatible with economic freedom. These latter regulations include all kinds of controls such as price, quantity, and wage control. Clearly, these coercive activities of the government represent the kind of infringement of the individual's private sphere which is an obstacle to individuals freely contracting with each others. So do, besides these regulations, all kinds of government monopolies for those goods and services

[18] Colombatto (1997) draws attention to the potential inefficiencies associated with providing these activities. In his argument, rent-seeking is the most important source of these inefficiencies. His argumentation is in line with Vanberg (2005, p. 36).

[19] For instance, there is no doubt that compulsory military service or some work regulations must be rejected on an efficiency ground, although these do not hamper individuals in making and following their plans on the market.

which could be otherwise provided on a competitive basis. The services or goods upon which the government does not have an agreed monopoly should be supplied by the government on the same terms as anybody else, otherwise economic freedom is hurt. If government is only one of many providers of these goods and services, this does not concern the issue of economic freedom. Clearly, it is not enough to examine the extent to which government gets involved in production or services; one should also examine whether it has a monopoly.

The third type of freedom-non-compatible coercive activities is government subsidies to particular firms (private or state) and various transfers which arbitrarily differentiate between agents. Transfers and subsidies should be seen as coercive actions because those who get particular subsidies are forced to behave not according to their plans but according to the government's will.

To sum up, freedom-compatible coercive activities can be taken into account and refer to everybody, whilst freedom-non-compatible ones are those that arbitrarily differentiate between individuals and/or cannot be accounted for. Table 2 summarizes the coercive activities of the government.

Table 2: Coercive governmental activities

Freedom-compatible activities	**Freedom-non-compatible activities**
Services that are necessary implications of the monopoly over coercion (enforcement of contracts and property rights, national security, etc.)	Controls • Price • Quantity • Wage
General rules and regulations laid down beforehand conforming to the rule of law (e.g. laws, work safety, and health regulation, etc.)	Services or production without agreed monopoly which should be provided on competitive grounds, but over which government has a monopoly
	Government subsidies to firms and transfers

4 The Significance and Empirical Relevance of Our Framework of Economic Freedom

An advantage of the above categorization schema of government actions, as we show in what follows, lies not only in the fact that it can be operationalized – that is, measured – but in the fact that it can point to a mechanism other than those identified in the literature[20] through which economic freedom may affect income. However, the use of the above-mentioned two indexes makes it impossible to reveal this mechanism.

4.1 Requirements Vis-à-Vis a Concept of Economic Freedom

The requirements a concept of economic freedom should fulfill are, we believe, not independent of what the concept is to be used for. Not surprisingly, the most common use of the indexes of economic freedom is the investigation of the growth of nations, through which one can show whether economic freedom increases growth or not, and how it affects growth. A concept of economic freedom which aims to explain growth should meet three requirements.

First of all, independent ofall other aspects of the analysis, a conceptual framework of economic freedom should be consistent in itself. That is, the system of concepts should be part of an internally logical structure. Secondly, agreeing with Block (2006), we also think that the concept of economic freedom should be broken down into operationalizable and measurable components. Measuring economic freedom means two things. First, it means that one is able to name "variables" to measure. Second, it also means that one is able to define a "mapping" between the values of the variables and economic freedom. To put it simply, one has to know what to measure and how what is measured relates to economic freedom.[21]

[20] Various channels, such as investment in human and physical capital, property rights, changes in inequality, social capital, and trust have been identified by different scholars. See Kapás and Czeglédi (2007) for details.

[21] For example, one has to know that the minimum wage is a variable to be measured, but one also has to know that a higher minimum wage means less freedom.

The above two requirements are general ones which can be raised in the case of any framework designed to understand economic freedom. The third is more specific, but, from our point of view, is at least as important as the above two. We argue that a theoretical framework of economic freedom should possibly be "integrated" into a growth theory by which, for the time being, we mean a theoretical explanation for the (inter)relationship between economic freedom and growth. This implies that before one begins to empirically examine the relationship between economic freedom and growth, one has to have a theory about how economic freedom leads to economic growth.

While the first two requirements are very much interconnected, the third is independent from the other two: those components of economic freedom that are measurable will probably create a coherent concept of economic freedom, but cannot necessarily be integrated into a theory of growth. Our claim here is that the theoretical concept we have just developed meets all the three requirements, and being so, it is a useful starting point for an analysis of the relationship between growth and economic freedom.

However, the empirical projects focusing on economic freedom have not paid sufficient attention to the third criterion. Even if this is understandable, since the aim was only to measure economic freedom, it prevents us from an understanding of economic freedom's contribution to growth. Elsewhere (Kapás and Czeglédi 2007) we argued that the problems the "economic freedom – growth" literature is currently facing are not purely empirical or econometric ones, but theoretical in nature, namely that the concept of economic freedom on which the measurement is based is not consistent with an economic freedom-based theory of growth. Instead, economic freedom is simply seen as a variable which is needed to augment theories of growth that do not work properly in the absence of economic freedom. But if one believes, as we do, that economic freedom should be at the center of a growth theory, the third criterion should be given equal weight with the other two.

Our aim here is to show that our theoretical framework is a good candidate for this. So far (in sections 2 and 3) we have tried to show that this framework is consistent in itself (requirement 1). Now, we come to its empirical relevance by showing that our high-brow concepts derived from the Hayekian notion of freedom can have practical meanings, making it measurable (requirement 2). Following this then we will point to how it allows us to explain how economic freedom leads to higher income (requirement 3).

4.2 From Theory to Measurement

A crucial point when trying to measure economic freedom is that we should keep in mind that freedom understood as the absence of coercion is defined "negatively." So in fact, what one has to measure is the absence of that coercion which relates to individuals' entrepreneurial acts. We argue that a possible fruitful way is precisely to measure economic freedom in the same (negative) way as it is defined. This implies that we should measure those elements that reduce economic freedom. In our conceptual framework this means that we have to measure those governmental actions that reduce economic freedom.[22] By proceeding along this line, the major difference between our proposition and the measurement concept of the EFW index will be found in the fact that ours excludes economic policy variables.[23]

As already emphasized, non-coercive government activities by definition do not hurt economic freedom, although they may increase the size of the government. So, when measuring economic freedom, we should focus our attention only on coercive activities. We argue that the extent of economic freedom can be reduced from two sides: (1) by the deviation from an *ideal* of the rule of law[24] (freedom-compatible government activities), and (2) by freedom-non-compatible government activities.

Thus the major task is to give a practical meaning to freedom-compatible activities, since the other set of coercive activities, namely freedom-non-compatible ones, includes measurable concepts as we will show below.

As far as freedom-compatible activities are concerned, what is to be measured is thus whether when acting, government relies only on rules laid down beforehand.

[22] We have to note that it is not our intention here to elaborate a precise methodology for this measurement, something which is beyond the scope of the present paper. Rather, our aim is to develop this measurement concept theoretically.

[23] Elsewhere (Kapás and Czeglédi 2007) we provided a detailed critique of the EFW index, and we showed why our conceptual framework of economic freedom refers only to institutional variables.

[24] As already argued above, the hypothetical perfect state of rule of law (the *ideal* of the rule of law) can be used as a criterion for reference.

However, on the other hand, it is equally important to know whether and to what extent, rules, once they exist, are followed in practice. This latter point is important because rules should not necessarily be codified; thus formal rules are not enough for us to decide whether an economy can be said to be governed according to the rule of law. We also need *de facto* practice, and in addition, we need *de facto* practice even if, as an extreme case, a country does not have any written rules. Here the problem we face is that written rules do not necessarily become effective constraints. There may be other factors that make the government behave in accordance with the rule of law.

Clearly, here two aspects of the way governmental actions are taken are intertwined. The first aspect concerns whether the government relies on rules when making decisions, since coercion is admissible only when it conforms to general rules and not when it is a means of achieving a particular aim of current policy. The second aspect relates to the extent to which the government is committed to follow the rules that it itself laid down beforehand. Thus one can imagine such a situation in which *de iure* the government is bound to rules, i.e. in principle it relies on rules, but in practice it does not keep to these rules in every respect. An obvious measurable proxy for the first aspect is the legal procedures themselves. To be freedom-compatible these procedures must pass the test of the Hayekian triangle of equality, certainty, and generality.

Corruption is of major importance for the extent to which rules are followed in a country; thus it is our suggested proxy to describe the second aspect of rule-following by government. Clearly, corruption can be interpreted as a principal-agent problem (Bardhan 1997, p. 1321). The level of corruption is zero if the agent behaves in accordance with those rules the principal (the public) laid down for him or her to follow. This standard understanding of corruption supports our view according to which the presence of corruption indicates the poor operation of the government in the field of freedom-compatible activities.

Although corruption is very often the result of the implementation of an unreasonably high level of regulation which is clearly a freedom-non-compatible action, we still think that corruption has to be a subtraction on the freedom-compatible side. The reason is that enacting regulations and enforcing regulations are different actions, and bureaucratic corruption[25] is the problem associated with the latter. But enforcing rules (via use of the monopoly in violence) is a freedom-compatible activity once the rules have been laid down. After all, the main reason why we think corruption relates to the freedom-compatible group of government activities is that it is a general measure of the rule-following of the government and the bureaucrats.

To sum up, as a deviation from the *ideal* of the rule of law, we propose to take into account, on the one hand, the legal procedures which reflect whether the legal system as a whole meets the requirements of the equality, generality, and certainty of the law, and on the other hand, the corruption which reflects a departure from the reliance on and commitment to rules (rule-following).[26]

Besides the deviation from the *ideal* of the rule of law, freedom-non-compatible government activities hurt economic freedom, too. Based on the analysis of the government activities we have developed in Section 3, we argue that economic freedom can be reduced in three respects. First, all price, quantity, and wage controls reduce economic freedom. Second, government services and production with a non-agreed monopoly also reduce it. And finally when government subsidizes particular firms or gives transfers, this is also against economic freedom.

What is the most problematic issue of these three is the state monopoly. As we have already argued, not every kind of state ownership reduces economic freedom. State ownership can reduce economic freedom only if it goes together with a monopoly in that sector. Or to put it simply, it is only state monopolies that reduce economic freedom, but not state owned enterprises as such. Thus it is not enough to have a measure of state-owned enterprises. We need to have a measure related to their monopoly power.

All things considered, we think that measuring freedom-non-compatible activities is much less troublesome than measuring freedom-compatible activities. Thanks to the increasing attention devoted to the subject of regulation and growth, there are

[25] It is usual to differentiate between bureaucratic and political corruption, and the more or less widely accepted indexes of corruption capture the former (Bardhan 2006, pp. 342-343).

[26] Note also that nowadays legal procedures and corruption are becoming the subject of measurement (Djankov et al. 2003, Bernd and Voigt 2007, Kaufman, Kraay, and Mastruzzi 2007), but not as elements of a theory of economic freedom.

relatively well-known and widely used datasets for this purpose, such as that compiled by the *Doing Business* project of the World Bank (the latest publication is in 2007), and some components of the two economic freedom indexes can also be used.[27] Although these data sets do not provide data for state monopolies as such, they do make some measurement possible by providing data for state ownership and for those regulatory burdens that reduce competition. All in all, we think that the concepts by which we described freedom-non-compatible activities in Table 2 are measurable in themselves; thus the problems arising when trying to measure what we have in mind are technical rather than theoretical.

4.3 From Theory of Economic Freedom to Theory of Growth

The reason, we believe, why our concept of economic freedom and its measurement is important is connected with the third requirement we stressed in section 4.1. We argue that our theoretical framework of economic freedom can be integrated into a theory of growth. It is perfectly compatible with the theory of entrepreneurship (Kirzner 1973), and it is through entrepreneurship that economic freedom deploys its beneficial effects (Harper 2003). The mechanisms through which entrepreneurship leads to growth are revealed by Boettke and Coyne (2003) and Holcombe (1998, 2003a, 2003b, 2003c). However, as far as the empirical literature on economic freedom is concerned, there is no agreement on the channels through which economic freedom deploys its beneficial effects, and here the benignity of economic freedom is underpinned only on an empirical basis.[28] Nevertheless, it is not empirical work that can tell us whether economic freedom is beneficial or not. We claim that a theory of economic freedom must contain arguments in favor of its desirability.

Arguing in favor of economic freedom means showing that it makes market participants better off; or in other words, it leads to economic growth. In addition, clarifying how entrepreneurship causes growth, at the same time, means revealing the mechanism through which economic freedom explores its beneficial effects.

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[27] It must be noted here that the most recent version of the two economic freedom indexes are already making use of the Doing Business data (Gwartney and Lawson 2007, Kane, Holmes and O'Grady 2007).

[28] For a detailed overview of the empirical literature on economic freedom, see Kapás and Czeglédi (2007).

Holcombe (1998, 2003a, 2003c) clearly argues for seeing entrepreneurship as leading to economic growth. The connection between economic growth and entrepreneurship lies in the fact that unnoticed profit opportunities come partly from the activities of other entrepreneurs.[29] The point is that when entrepreneurs are taking advantage of profit opportunities they create new entrepreneurial opportunities for others; that is, "entrepreneurship creates an environment that makes more entrepreneurship possible" (Holcombe 1998, p. 51).

What was said above contributes to the recognition of two facts that are crucial for growth theory (Holcombe 1998). First, knowledge externalities occur, since one entrepreneurial insight may produce entrepreneurial opportunities for others. Second, increasing return occurs because the more entrepreneurial activities take place, the more new entrepreneurial opportunities they create. Recognizing that both knowledge externalities and increasing return are due to entrepreneurship, it becomes clear that the engine of growth is not better inputs, but those institutions which fuel entrepreneurship. That is, in this framework the key element in economic growth is the creation of entrepreneurial opportunities, in which institutions play a crucial role (e.g. Holcombe 2003a, Boettke and Coyne 2003, 2006).

Based on the above, our argument is that the theory of economic freedom must pay more attention to investigating which institutions promote economic freedom by providing incentives for individuals to engage in productive entrepreneurial activities, which in turn causes growth, and how these institutions achieve this. Our categorization of government actions can be useful in this theorizing because the distinction between freedom-compatible and freedom-non-compatible government actions provides us with an unambiguous criterion for qualifying an institution as promoting freedom or not. Note also that the Hayekian theory we laid down is about economic freedom itself and not about efficient economic policy. These two may or may not overlap, opening up the possibility for theoretical and empirical research into the separate effects of economic freedom and sound economic policy on economic growth.

[29] Two other factors that create profit opportunities are as follows: (1) factors that disequilibrate the market, (2) factors that enhance production possibilities (Holcombe 2003b).

5 Conclusions

In this paper, we have developed a concept of economic freedom based on Hayek (1960), and as a step further, we have proposed a categorization of government actions, which allowed us to conceptualize the measurement of economic freedom in a different way from that of the indexes of economic freedom. As we argued, a clear-cut concept of economic freedom is important not only for ranking countries according to a scale, but more importantly, for developing new substantial results as regards how economic freedom affects growth. In other words, we think that empirical investigations are important, but a theoretical framework must come first, and measurement after if possible.

In our view the major problem with the literature on economic freedom lies in the fact that it does not put economic freedom at the center of a theory of growth, something which would be necessary in order to investigate the causes of "the wealth of nations." However, one should have this aim in mind, we argued, even before a measurable concept of economic freedom is developed. This is the fundamental reason why we are currently trying to develop another measure of economic freedom, even though two – in other respects very good – indexes already exist. Because of a lack of attention to the criterion we emphasized, namely that a theory of economic freedom should be compatible with a theory of growth, the empirical investigations into how economic freedom affects growth have only very weak theoretical interpretations, preventing researchers from taking the research further and concluding more than the simple fact that economic freedom increases economic growth.

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