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Economic Freedom and Government: A Conceptual Framework

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Abstract

The aim of this paper is to contribute to the development of a theory of economic freedom. In this endeavor, we build our framework on the Hayekian notion of freedom (Hayek, 1960) because it explicitly embodies the obvious link between freedom and the state: freedom is an absence of state coercion except for that which enforces abstract, general rules known beforehand. We derive two propositions from this Hayekian thesis and elaborate on them, leading to a categorization of government actions from the viewpoint of economic freedom in which the criterion against which coercive governmental actions must be evaluated is the rule of law, meaning a government's reliance on general, abstract rules. As an implication, our framework allows us to argue for the imperative differentiation between "efficiency" and "economic freedom" as two separate criteria against which government actions can and must be evaluated. We also show that our framework may help explain the process through which economic freedom enhances growth.

KEYWORDS: economic freedom, government, coercion, Hayek

Author Notes: We thank our anonymous referees for helpful comments and suggestions.

1. Introduction

Since Adam Smith, who was the first to *explicitly* raise the importance of a system of natural liberty¹ (in modern parlance economic freedom), the issue of economic freedom has been a subject of little interest among economists, except for Hayek (1960); however, over the past 15 years the concept of economic freedom has attracted more attention.² This is due to the construction of two widely used indexes of economic freedom³. Using these indexes, a growing body of empirical research analyzing the role of economic freedom on growth has emerged, whose major finding is that economic freedom raises long-run income or growth (e.g., Easton and Walker, 1997; De Haan and Sturm, 2000; Gwartney et al., 2004, 2006).

However, beyond the well-documented argument that economic freedom increases growth, this line of the literature cannot provide an exact answer to the question of *how* and *why* economic freedom enhances growth or long-run income, a question which is related to today's most pressing economic problem, namely why some countries grow while others do not. In addition, the *why* and *how* question is in general reduced to asking which components of an economic freedom index contribute to growth to the greatest extent (see e.g., Carlsson and Lundström, 2002; Dawson, 2003). What, at the most fundamental level, prevents the empirical literature from developing a new dynamism in investigating economic freedom's growth-enhancing effect is that even despite the existence of the economic freedom indexes and their extensive use in various empirical investigations, a theory of economic freedom itself is still missing; a theory that, most importantly, must also include an explanation for the *how* and *why* question.

¹ Where "[e]very man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men" (Smith, 1776, Book Four, Chapter IX). Available: <http://www.adamsmith.org/smith/won-b4-c9.htm>. Accessed January 5, 2010.

² Before Adam Smith described a consistent system of natural liberty, many other scholars recognized different aspects of the beneficial effect of economic freedom. The most distant predecessors to Smith may be the scholars of the School of Salamanca, who worked mainly in the 16th century (Grice-Hutchison, 1952; Rothbard, 2006:101-116). They originally developed several ideas which later became reinvented as the building blocks of laissez-faire thinking. In particular, they were aware of the working mechanism of demand and supply, and developed a theory of natural law that was explicitly connected with the (perhaps more theological than economic) question of the free will of man and with a commitment to freedom (Rothbard, 2006:115-116). We are grateful to an anonymous referee for drawing our attention to this school.

³ These indexes are: the one developed by the Fraser Institute (Economic Freedom of the World (EFW) Index; for the most recent version see Gwartney and Lawson, 2009), and another constructed by the Heritage Foundation jointly with the Wall Street Journal (Index of Economic Freedom; for the most recent version see Miller and Holmes, 2009).

Even Block (2006), one of the fathers of the EFW Index, acknowledges that the construction of the index was largely driven by operational and measurement considerations, rather than with the intention of deriving a theory of economic freedom or of its effects. This is, however, not to say that the indexes are not grounded on clear concepts; on the contrary, the EFW Index, for example, was developed as a result of a series of conferences in which many distinguished scholars, including Nobel Laureates, participated. Scholars at these conferences engaged in thorough discussions – and later published their results in books – about what economic freedom is and what should be integrated into an index designed to measure it (see Walker, 1988; Block, 1991; Easton and Walker, 1992). But measurement being the primary aim, the EFW Index was not designed in such a way as to make it possible to analyze in depth the above questions related to the causes and process of economic development.⁴

In this paper we do not want to criticize the indexes of economic freedom, nor the empirical literature on economic freedom; instead we intend to contribute to the development of a theory of economic freedom. Acknowledging that the development of the theory of economic freedom is a larger research project, here we will lay down only the conceptual framework.

In our endeavor we were to a large extent inspired and influenced by Hayek (1960, 1973). Our starting point is the Hayekian notion of freedom because it explicitly embodies the obvious link between freedom and the state, a link which is indeed, although mostly implicitly, widely acknowledged by scholars. Hayek (1960) defined freedom in terms of state coercion:

Freedom demands no more than that 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, 1960:144)

We derive two important propositions from this Hayekian thesis. First, since in the spirit of Hayek, economic freedom and government are not antagonistic *per se* but at the same time government represents *the* major threat to economic freedom, economic freedom is best conceptualized in terms of types of government actions. Second, a criterion against which coercive governmental

⁴ One major issue which is now at the forefront of research is that of the possible endogeneity of institutions and policies of economic freedom in the development process (Faria and Montesinos, 2009). To be able to formulate hypotheses as regards which institutions and policies constituting economic freedom are endogenous requires some *a priori* theorizing about economic freedom with this question in mind, but the components currently used in an economic freedom index were not constructed with this aim. See also our argumentation in the Conclusions section.

actions have to be evaluated is the rule of law. Here, in its Hayekian meaning, the rule of law refers to whether the government enforces only general, abstract rules known beforehand, a meaning which is different from seeing the rule of law simply as a component of economic freedom as both indexes do (see Section 4). As an implication of these two propositions, we will explicitly differentiate between freedom-compatible and freedom-non-compatible coercive government actions, a distinction which serves as a cornerstone in an explanation of the relationship between state, coercion and economic freedom. This framework leads us to consider “economic freedom” and “efficiency” as two separate criteria against both of which government actions can and must be evaluated.

We clearly argue that further work is needed; on the one hand, on the operationalization of our conceptual framework, which may lead to the improvement or possible restructuring of the indexes measuring economic freedom, and on the other hand, on various theoretical issues such as the connection between economic freedom, entrepreneurship and institutions, which may help explain how economic freedom induces growth. It is precisely these two paths for further development that underpin the significance of our conceptual framework.

The rest of the paper is organized as follows. In Section 2 we will present the root ideas concerning economic freedom, namely those of the Scottish philosophers of the Enlightenment, and ideas built upon these, namely those of English classical economics and Hayek. In Section 3, taking a step forward, we will highlight the link between coercion, the state and freedom, and, based on this analysis, in Section 4 we will explore the content of economic freedom and its relation to the rule of law. In Section 5 we will categorize and analyze governmental actions in terms of their relation to economic freedom. Section 6 concludes.

2. From the concept of the state of nature to that of economic freedom

The theoretical foundations of Hayek’s views on freedom were developed by the Scottish philosophers of the Enlightenment and the English classical economists. Although neither Locke and Hume nor Smith used the term “economic freedom” explicitly, they developed insights which, in fact, are related to economic freedom.

John Locke’s *Second Treatise on Civil Government* (Locke, 1690) founded a coherent and powerful intellectual tradition, in which he provided the first coherent justification for private property as the foundation of social order (Rabushka, 1991:27). According to Locke, private property was essential to preserve the individual freedom that individuals enjoyed in the state of nature which is “a state of perfect freedom to order their actions, and dispose of their

possessions and persons as they think fit, within the bounds of the law of Nature, without asking leave or depending upon the will of any other man” (Locke, 1690:106). Based on this, he argued that the primary goal of government is the defense of property under the rule of law. In this way, he was arguing for the institutions of laissez-faire capitalism where the government’s role was little more than a night-watchman’s. David Hume (1739) reinforced Locke’s views. Hume was the first to formally identify those institutional characteristics that are necessary for promoting the socially beneficial economic behavior of individuals (Hayek, 1988:34). These are the recognition of private property rights and the application of the rule of law to govern private transactions.

In fact, both Locke and Hume argued for the type of government that in modern parlance is called “limited government”: Locke’s idea was that the proper role of the government is to protect the natural rights of individuals, while Hume’s view was that the government is legitimate as long as it serves a particular purpose, namely securing peace and property rights. The government, in the state of nature, cannot act arbitrarily (Locke, 1690).

All these views are to some extent echoed by scholars in English classical economics (e.g., Smith, 1776; Mill, 1860). As mentioned in the previous section, Adam Smith recognized the importance of natural liberty (economic freedom) more than 200 years ago. In providing an answer to the question of why some nations are rich while others are poor he emphasized the role of the system of natural liberty (together with that of specialization and exchange), which is, au fond, a type of explanation of the effects of economic freedom on growth. Mill’s essay (1860) *On Liberty* was also a very influential work which advocated the moral and economic freedom of individuals from the state. In this essay Mill was concerned with developing ideas regarding the nature and limits of power that can be legitimately exercised over individuals in a society.

The important lesson to be drawn from the ideas of the above scholars is that government and economic freedom are not antagonistic *per se*. As suggested by the idea of “limited government”, government *per se* is not to be condemned; instead, it fulfills some positive roles that cannot be fulfilled by any other actor in a society. According to Locke, this role is the defense of private property, in Hume’s view this is the application of the rule of law, and in Smith’s (1776) view the major role of the government is to provide protection against private coercion and to provide public goods.

After a relatively long silence on the issue of (economic) freedom following the emergence of the intellectual tradition described above, Hayek (1944[1971], 1960, 1973) was the first to develop an explicit theory on freedom. He defined freedom as an absence of state coercion except for that which enforces abstract, general rules known beforehand (see the quotation in the previous section). This thesis, on the one hand, reinforces what Locke, Hume, Smith and

Mill argued. Hayek also made it clear that government and freedom will only be contradictory if government expands beyond certain limits, and what is more, he provided us with a criterion to determine these “limits”. This criterion is the rule of law, a state under which the government is prevented from acting on an *ad hoc* basis; accordingly where it is possible to foresee with fair certainty how the authority will use its coercive power. So in the spirit of the above, we propose to translate the Hayekian thesis into two propositions.

The first is that economic freedom is compatible with government, but not with any kind of government.⁵ Based on this, in order to come closer to a conceptualization of economic freedom one should analyze the actions of the government according to their character. Accordingly, when it comes to economic freedom it is not the size of the government that matters, as is also explicitly argued by Hayek (1960:221-224), Mises (1949:279-287) or Pejovich (2008:42), but rather *what* government is allowed to do and *how*: economic freedom relates to the *character* of government actions, rather than the *volume* of government actions (more details in Section 5).

The second proposition is that the *character* of government actions has to be evaluated according to whether the government relies on abstract, general rules known beforehand when exercising its coercive power or whether the actions are arbitrary, a criterion which is embodied in the principles of the rule of law. Thus, what the rule of law provides us with is precisely a criterion against which one should evaluate the actions of the government from the viewpoint of economic freedom. Clearly, in this interpretation, the rule of law is not only a characteristic of the legal system; neither is it just one component of economic freedom among many others as it is in the indexes of economic freedom (see Gwartney and Lawson, 2009, and Miller and Holmes, 2009).⁶ Instead, here the rule of law

⁵ By adopting our position we disagree with Rothbard, an influential Libertarian economist, who rejects any role for government. In his book of 1962[2004], he developed the feasibility of a totally stateless economy, and in his book of 1982[1998] he described the ethical foundations for individual liberty. Note also that the view that the state and freedom are not inherently antagonistic is not to deny that the state represents a threat to freedom.

⁶ To be clear, in this respect it is imperative to distinguish the Hayekian meaning of the rule of law from the concept that is very often used in the literature, mainly in econometric investigations in which different measures of the rule of law are generally included as an explanatory variable in growth regressions. Knack and Keefer (1995) were the first to use measures of the security of property rights compiled by country risk rating agencies in terms of the rule of law. Since then a huge literature has examined the effect of various measures of the rule of law on economic performance. Reviewing this literature, Haggard et al. (2008) showed that the term “rule of law” is used to describe very different aspects of the legal system. In many cases it means the security of property rights, while in others it refers to the institutional constraints on government, the level of corruption, or the independence of the judiciary. These measures, as shown by the review of the empirics in Durlauf et al. (2005), are usually found to be a significant determinant of economic growth with a positive effect.

operates as a guide for the government on how to use its coercive power. As such, the rule of law cannot be measured on the same scale as other policy or institutional variables, because different economic policies or institutional settings bringing about the same final results can be evaluated differently through the lens of the rule of law. Briefly, the rule of law in this respect is rather the scale itself which is to be used to evaluate particular governmental actions, than a component of economic freedom (more details in Section 4).

An advantage of relying on the Hayekian concept of freedom is that it explicitly, and what is more important, at a theoretical level, embodies the obvious link that exists between freedom and state coercion. This link is made evident by the scholars we referred to in the previous paragraphs, and since then it has become widely accepted among scholars in general. Accordingly, theorizing on economic freedom involves theorizing on the state (government), coercion and the rule of law. In what follows our aim will be to explore the relationship between them.

3. Coercion, state, and freedom

There are two general explanations for the state: social contract theory and predatory theory. The former, by its nature, presumes a state that does not reduce economic freedom as we understand it (for this reason we will not deal with this line of the theory), while the latter – suggesting that the state emerges out of the self-interested behavior of some agent with a comparative advantage in using force – asserts that state coercion can reduce economic freedom. In this perspective coercion, state and freedom are closely related. In this section we will explore this relationship.

It follows from what we have already discussed that coercion is a crucial concept for making sense of freedom. In the traditional approach (e.g., Hobbes, Locke, Kant) coercion has commonly been understood as the use of a certain kind of power for the purpose of gaining advantages over others (including self-protection), punishing non-compliance with demands, and imposing one's will on the will of other agents. In other words, it was viewed as capturing something and thus related to violence, compulsion, punishment, force, or interference, or the threat of these.⁷

Hayek's concept of coercion is in accordance with the above understanding:

⁷ Note that Nozick (1969) associates coercion only with proposals (e.g., conditional threats), and excludes the direct uses of force or violence which has, explicitly or implicitly, been adopted by many theorists, and has become the dominant strand (see also Stanford Encyclopedia of Philosophy, available: <http://plato.stanford.edu/entries/coercion/>, accessed January 5, 2010).

Coercion occurs when one man's actions are made to serve another man's will, not for his own but for the other's purpose. (Hayek, 1960:133)

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 – authors' addition) is forced to act not according to a coherent plan of his own, but to serve the ends of another (the coercer – authors' addition)" (Hayek, 1960:21).⁸

As follows from what was said above, there are, of course, several forms of coercion, of which the threat of violence or physical force is the most important, and even in this form there are many degrees of coercion:

True coercion occurs when armed bands of conquerors make the subject people toil for them, when organized gangsters extort a levy for 'protection', ... when the state threatens to inflict punishment and to employ physical force to make us obey its commands. (Hayek, 1960:137)

Having said that, the important question is whether all forms of coercion are absolutely negative or whether it is in our interest to tolerate some kinds of coercion. History shows that institutionalized coercion by private (non-governmental) parties is almost never tolerated, and is not morally acceptable, except when it arises from consent (Blake, 2001), but we tolerate governmental coercion. Why do we tolerate infringements of property and liberty rights by governments? The reason is that the coercive power of the state is useful when it protects our lives and property from private coercion. But what constitutes the state's coercive power and what justifies a degree of state coercion?

As one line of the literature (Barzel, 2000, 2002; Benson, 1998, 1999; Hayek, 1973; Holcombe, 2004; Olson, 1993, 2000; North et al., 2009) argues, all modern nation-states evolved from extortionist institutions, and states remain the primary threat to secure property rights, and accordingly, to (economic) freedom. However, on the other hand, as shown by Holcombe (2004) and Olson (2000), the government (state) is desirable, because it is less predatory than the bandits or mafias that would exist in the absence of a state.

⁸ Here it must be noted that Hamowy (1961) heavily criticized Hayek's understanding of freedom as the absence of coercion, and in the framework of his criticism he attacked Hayek for the definition of coercion, too. In his answer to Hamowy, Hayek made it clearer what coercion means, by drawing a line between a coercive and non-coercive action: "To constitute coercion it is also necessary that the action of the coercer should put the coerced in a position which he regards as worse than that in which he would have been without that action" (Hayek, 1961:71). See also footnote 14.

In the above-cited literature, the emergence of a government (state) with a coercive monopoly, or alternatively an ordered anarchy⁹ is explained in terms of an organic process in which some individuals develop a comparative advantage in violence. Violence is important because of scarcity, which, indeed, leads inevitably to a competition over the use of an asset. When numerous groups with coercive power (protection firms or Mafias) exist, clearly, they compete with each other, leading, as Nozick (1974) argues, to a natural monopoly in this industry. The way this process takes place is best explained by Olson (1993, 2000).

At the end of the day, what this line of the literature shows is that the evolution of predatory (roving) bandits into stationary bandits (protection firms) and accordingly into governments is not only inevitable but is also desirable because the encompassing interest of the stationary bandit limits his predations, by securing individuals' property rights.

But the state must be seen as the primary source of threat for individuals' freedom because as Weingast (1993, 1995) argues when the government is strong enough to protect property rights and enforce contracts, it is also strong enough to take the wealth of citizens.¹⁰ For our concern the major question is in which field(s) government coercion is allowed. Ultimately, the question at hand concerns the ends to which coercion may be put: What forms of coercion are justified?

In a society organized as a state, individuals must tolerate some coercion – because “without some sort of state coercion, the very ability to autonomously pursue our projects and plans seems impossible” (Blake, 2001:280) –, this coercion is that of the state which protects us from the coercion of others:

As far as the government ... confines the exercise of its violence and the threat of such violence to the suppression and prevention of antisocial action, there prevails what reasonably and meaningfully is called liberty. (Mises, 1949:281)

⁹ Under ordered anarchy individuals develop private institutional solutions such as property rights or mutual insurance arrangements to address the problems that statelessness presents. Leeson (2008) provides an example of this in which he presents the well functioning private system of governance of pirates. Furthermore, Benson (1999) shows the conditions under which an ordered anarchy may appear to be quite stable, while Leeson (2007) does the same for those under which anarchy may be efficient.

¹⁰ As argued in the institutional economics literature, the crucial thing is to have such institutions that credibly commit the state to constraining its own appropriation, and furthermore this commitment must be self-enforcing (Weingast, 1995). More precisely, the state itself must make credible commitments not to use its coercive force to extract too much of individuals' surplus or property. A critical role of the constitution and other political institutions is precisely to place restrictions on the state (North and Weingast, 1989; Weingast, 1997).

Nevertheless, 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. In other words, the great difficulty is that coercion is both necessary and terrifying (Glaeser, 2007). Accordingly, freedom does not mean a total absence of state coercion.

A conclusion from what was discussed above concerning the emergence of the state is that state coercion *per se* is not to be condemned: the only acceptable end to which government can use its coercive power is to protect us from private coercion. Having said that, the question is which means are acceptable for the government to employ its coercive power? This leads us to our second proposition derived from Hayek (1960) which has been already presented: the only acceptable means is enforcing general, abstract rules known beforehand, which are embodied in the principles of the rule of law.¹¹ Thus, we argue that the rule of law is a set of principles that constitutes a criterion for an evaluation of coercive government actions from the viewpoint of economic freedom. This assertion, together with an unbundling of the content of economic freedom, will be developed in the next section.

4. The content of economic freedom and the rule of law

Although Hayek (1960, 1973) does not differentiate between various types of freedom, such as political or economic freedom (except for in his 1944[1971] book), 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 general, abstract rules known beforehand. In this spirit, when it comes to economic freedom, state coercion should be understood as concerning the economic activities of individuals; more precisely their entrepreneurial acts.

In a state of economic freedom individuals are allowed to use their knowledge for their own purposes in the course of making and realizing their plans in the market (Hayek, 1937). Put differently, individuals can exploit their productive potential by following their own plans and the opportunities to amass wealth safeguarded against confiscation (Barzel, 2000), i.e., they are able to have control over the residual of their productive efforts. The only constraint they have is that they are obliged to pay a certain share of their wealth (income) to the state, a share which is known beforehand; otherwise they are free to contract with any

¹¹ Note that one should not confuse the Hayekian idea of a government relying on general rules which, as we argue, is an economic freedom issue with that of economic policy based on rules which is an economic policy issue.

other individual in the market at any price. The crucial thing is that the state should allow people to rely on “the knowledge of the particular circumstances of time and place” (Hayek, 1945:521), because only individuals know these particular circumstances.

Why is it so important that individuals be able to use their knowledge? The answer is rooted in what Hayek argued in his seminal 1945 paper: when individuals are allowed to mobilize their subjective, local knowledge, this leads to a situation in which the greatest possible advantages from trade can be achieved.¹² Put differently, a condition of economic freedom is that which gives all market participants the opportunity to act according to their own economic plans and use their skills and knowledge in the pursuit of their goals, i.e., deploying their entrepreneurial activities. The higher the level of economic freedom, the better consumer choices are satisfied and the greater the set of profitable production possibilities exploited. According to Hayek (1944[1971]), the competitive market process should be regarded as superior not only because it is the most efficient method to allocate resources, but even more because it is the *only* method by which individuals’ activities can be adjusted to each other without the coercive intervention of the government.

Having stated this, supposing that the government eliminates all kinds of private coercion (except for that arising from consent), it is clear that it is *only* governmental coercion that can violate economic freedom. However, as already argued above, state coercion which serves to eliminate private coercion is useful. Then the question is how to separate these useful coercive actions of the state from those reducing economic freedom? In providing an answer to this question we should continue to follow Hayek’s (1960) argumentation: “When we obey laws, in the sense of general abstract rules laid down irrespective of their application to us, we are not subject to another man’s will and are therefore free” (Hayek, 1960:153), and “[s]uch a system is likely to be achieved and maintained only if all authority is limited in the exercise of coercive power by general principles” (Hayek, 1973:55). By general principles he means the rule of law:

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]:54)

Thus, our argument is that the rule of law is a criterion against which one should evaluate coercive government actions from the viewpoint of economic freedom.

¹² More precisely, this is the reverse interpretation of what Hayek (1945) said, but we believe Hayek’s original emphasis (that the competitive market process is the most efficient way to mobilize individuals’ knowledge) implies this, too.

Although the rule of law is a historical concept suggesting some positive attributes, the concept is ambiguous and even legal scholars argue over its exact meaning. Fallon (1997) however, by identifying four ideal types of the rule of law, makes it clear that when various scholars treat it differently, they only prioritize the rule of law differently, reflecting the four ideal types. The Hayekian understanding of the rule of law reflects the procedural or formalist ideal type.

The formalist (procedural) ideal type associates the rule of law with form, not substance, and implies that constitutional decision-making should be cast in the form of rules (see also Buchanan, 1999), which reflects the assumption that clear and determinate rules are necessary for both citizens and those in power. This understanding of the rule of law suggests at the same time that the rule of law must be distinguished from the rule of “good” law; that is, this strand of conceptualization of the rule of law by itself gives no indication what the substantive content of rules should be. As Cass (2004) argues, the rule of law does not assure that rules are wise or just or whatever; the focus of the rule of law is to assure law-bounded qualities. When rules are conceptualized in this way, the distinction between rules and standards is not always sharp; “ruleness” is a matter of degree (Fallon, 1997).¹³

In sum, what is emphasized in the above conceptualization of the rule of law is government’s reliance on general, abstract rules known beforehand.¹⁴ According to Hayek, the rule of law includes the following 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. It means that entrepreneurs can expect that today’s rules will be tomorrow’s rules, that is, the law is not subjected to sudden and unpredictable changes. Under the certainty of law individuals can make long-run plans (Leoni 1961:95).

¹³ The significance of this for our framework will be clear when classifying coercive government actions. See Section 5.

¹⁴ Here, as in footnote 8, Hamowy’s (1961) famous criticism must be dealt with once again. Besides the concept of coercion, the other major line of his criticism was against Hayek’s understanding of the rule of law as government reliance on general, abstract rules laid down beforehand. Hamowy argued that even rules which are general and abstract may still restrict individual liberty, and he gave conscription as an example. In fact, he tried to show that Hayek’s definition of freedom is not viable. Seemingly, Hamowy associated the rule of law with substance, which, in our view, should not be considered a “true” criticism vis-à-vis the Hayekian view, but rather another possible conceptualization (ideal type) of the rule of law (see Fallon, 1997 for the various ideal types of the rule of law). The fact that Hayek and Hamowy conceptualized the rule of law in a different way is highlighted not only in Hayek’s (1961) original response to Hamowy, but also in his 1973 book in which he referred once again to Hamowy (Hayek, 1973:101, footnote 10). However, as will become clear in Section 5, our framework for an understanding of economic freedom which differentiates between the criteria of economic freedom and efficiency may be useful when dealing with Hamowy’s problem of conscription and similar government actions.

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: “Abstract rules are not likely to be invented by somebody concerned with obtaining particular results” (Hayek, 1973:87). 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). Thus, general abstract laws are long-term laws and are forward looking in their effect.

Equality of the law means that all legal rules apply to everybody including to those in power. That is, every individual, whatever his or her 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. This is the fact that administrative discretion in coercive power must always be subject to review by independent courts, that is, there must be some authority which is not concerned with any temporary aims 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.

Clearly, the rule of law tames the discretionary power of government and enables individuals to pursue their private ends. It gives us guidance to determine what kinds of coercive actions the government can take in an economically free country: specifically only those actions that conform to the principles of the rule of law (understood as described above).¹⁵

Under the rule of law individuals are able to form plans based on their knowledge, since laws are data for them, which can be accounted for, and the content of the law itself is irrelevant from this perspective, as was argued above.¹⁶ In sum, for our concern 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]:54).

The major conclusion from the above discussion is that under conditions of economic freedom government coercion is restricted to that coercion which aims at enforcing abstract, general rules known beforehand.

¹⁵ Note that Hayek clearly associated the rule of law with the common law: “such law, which like the common law, emerges from the judicial process is necessarily abstract in the sense that the law created by the commands of the ruler need not be so” (Hayek, 1973:86). For a detailed account of the historical evolution of the rule of law in the Anglo-Saxon tradition (England and the US) see for instance North et al. (2009) or for a short but excellent one see Johnson (2008).

¹⁶ Note however that the content of the law is important from the viewpoint of efficiency. See argumentation in Section 5.

5. Types of government actions and economic freedom

As suggested above, the coercive actions conforming to the rule of law are useful and foster economic freedom because they allow individuals to make plans and realize them on the market. We call them freedom-compatible coercive activities. But when government coercion is not restricted to coercive actions based on general rules, these arbitrary government activities hamper or distort individuals' entrepreneurial activity, and accordingly economic freedom is hurt. We call them freedom-non-compatible coercive activities. Let us consider these two kinds of coercive actions of government in more detail.

Freedom-compatible activities include first of all those coercive activities which serve to protect individuals from private coercion, such as the enforcement of contracts, an independent judiciary, the security of property rights, national security, etc. These coercive actions of the government are prerequisites for individuals' entrepreneurial actions to take place, therefore they are useful, an argument which is given strong theoretical and empirical underpinnings in the literature, too (e.g., Boettke and Coyne, 2003, 2006; Bjørnskov and Foss, 2008; Harper, 2003).

On the other hand, those general regulations and standards that are laid down in the form of rules specifying a certain type of activity, conforming ideally to the principles of the rule of law must be considered freedom-compatible activities, too.¹⁷ 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, or by prohibiting the use of certain materials, and so forth. These regulations, as is also argued by Hayek (1944[1971]) himself are fully compatible with the preservation of market competition, i.e., economic freedom. The only question here is whether the benefits are greater than the social costs they impose, since these regulations raise the cost of production. This evaluation, however, is made not according to the criterion of economic freedom, but that of efficiency¹⁸: some work regulations must be rejected on grounds of efficiency,

¹⁷ As argued in the previous section, in the formalist ideal type of the rule of law, which we adopt, there is no sharp distinction between rules and standards.

¹⁸ 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). One example of a conflict between the two criteria (freedom or efficiency) is shown by the debate over Richard Epstein's theory of strict liability as opposed to the negligence theory in tort law (Fay, 1992). By emphasizing the priority of the original assignment of property rights Epstein's theory of strict liability seems to be in line with economic freedom, although in some cases it might not be efficient. The reverse is true in the case of negligence theory.

although these do not hamper individuals in making and realizing their plans on the market (more details below).

The other group of coercive actions is that of freedom-non-compatible actions which the rule of law excludes in principle. Here there are those coercive activities of the government which cannot be achieved by enforcing abstract rules, but which involve arbitrary discrimination between people. Hayek (1960) is rather implicit on which government actions belong to this category, but in our view basically three types of actions emerge from his discussion. First, all kinds of controls such as price, quantity and wage control are of this type. These represent a kind of infringement of the individual's private sphere which is an obstacle to individuals freely contracting with each other. Furthermore, government monopolies on markets other than that of public goods harm economic freedom, too, because they prevent individuals from taking entrepreneurial actions on these markets. In fact, in this case the Hayekian principle that the government, except for the monopoly of coercion, should operate "on the same terms as anybody else" (Hayek, 1960:223), would be broken. In our view, the third type of freedom-non-compatible coercive activities is government subsidies to particular firms (private or state) and various transfers which are designed to achieve some specific purposes, and accordingly arbitrarily differentiate between agents. Clearly, these contradict the principles of the equality and generality of the law. Transfers and subsidies in this case should be seen as coercive actions because those who receive particular subsidies are forced to behave not according to their plans but according to the government's will (Hayek, 1960): subsidies are usually provided for a given purpose (R&D, exportation, etc.), and many transfers are not for free use (e.g., food stamp or housing benefits). In addition, very often, subsidies and transfers are provided based on concrete, particular rules, and not general, abstract rules conforming to the rule of law. Furthermore, due to, for instance, frequent changes in transfer and subsidies policy, individuals cannot foresee the action of the state with fair certainty. One reason for this is that the willingness of the government to grant money to any interest group will increase the expected profit from lobbying for such grants for all the other interest groups as Tullock (1967) pointed out decades ago. The outcome of this competition for grants is increasingly uncertain the more interest groups are involved.

So far, we have focused on coercive government actions, but not all government actions are coercive in character. Government undertakes some "purely service activities" (Hayek, 1960:144), too, which are non-coercive. These include the provision of those "services which otherwise would not be supplied at all" (Hayek, 1960:222), such as for instance care for the disabled, the provision of roads or of information, etc.¹⁹ It is true, however, that the only means by which

¹⁹ Note that this group of government actions is not identical with public goods, most importantly because public goods include coercive activities, too, such as enforcement of property rights and

these services can be financed is taxation, which is coercive. But, we argue that a government action has to be evaluated in terms of the *character* of the action itself, rather than how it is financed.²⁰ When evaluating a government action according to whether it reduces economic freedom, the emphasis on the *character* of the action itself provides us with a criterion referring to the feasibility of individuals' entrepreneurial actions, a criterion which would be missing when interpreting a coercive action in terms of coercive financing. To give an example, in terms of financing all government actions are of the same type, namely coercive, but in terms of the *character* of government actions, for instance the care for the disabled does not prevent anybody from making and realizing a plan on the market, accordingly it is a non-coercive action, while rent control distorts prices and hinders certain market transactions, accordingly it is a freedom-non-compatible coercive action.

What is important from the viewpoint of economic freedom is that government services (non-coercive government actions) do not concern economic freedom, while they influence the *size* of the government. The extent of government services and the taxes financing them matters, but from the viewpoint of efficiency. We argue that "efficiency" and "economic freedom" are criteria in their own right, providing different viewpoints for evaluating government actions. Efficiency is a criterion on the basis of which all government actions, both coercive and non-coercive, can and must be evaluated, while economic freedom is only concerned with evaluating coercive government actions. In this way efficiency is related to the *size* of government, while economic freedom is concerned with the *character* of government actions. In other words, the *size* of the government – which is the result of both coercive and non-coercive government actions – does not necessarily hurt economic freedom, while nothing guarantees that the government carries out its actions in an efficient way. That is, a government action can harm both economic freedom and efficiency, as for instance freedom-incompatible actions can; but an action harming efficiency may

contracts, and an independent judiciary, which we categorize as freedom-compatible coercive actions (see above).

²⁰ This is the reason why we did not mention taxation among the coercive government actions: a coercive action for us means "coercive in *character* of the action itself", and not coercively financed. (See Hayek (1960:222) which is in line with our argument). What is more, seeing taxes that are raised to finance freedom-non-compatible government actions as a factor reducing economic freedom would be a "duplication", once the freedom-non-compatible actions are seen as such. As for the freedom-compatible actions, since they do not reduce economic freedom, neither should the taxes financing them be seen as a reducing factor. Mises (1949:282), arguing that taxation for the purpose of financing such government apparatus as courts, police, armed forces, etc. is compatible with freedom seems to support our view. Note however that both indexes of economic freedom explicitly see taxation as reducing economic freedom, a point which is criticized in De Haan and Sturm (2000).

not harm economic freedom as, for instance, non-coercive and freedom-compatible coercive actions may. In the spirit of Hayek, it is also clear that hampering economic freedom is more harmful than acting in an inefficient way:

... [A] government that is comparatively inactive but does the wrong things may do much more to cripple the forces of a market economy than one that is more concerned with economic affairs but confines itself to actions which assist the spontaneous forces of the economy. (Hayek, 1960:222).²¹

So an evaluation of government action against the criterion of economic freedom must come first, and an evaluation against efficiency only second. Table 1 summarizes the types of government actions in relation to the two evaluation criteria.

Coercive actions				Non-coercive actions
Economic freedom criterion: conformity to the rule of law				
Freedom-compatible actions (conforming to the rule of law)		Freedom-non-compatible actions (not conforming to the rule of law)		
Rules	Regulations, standards	Rules	Regulations, standards	
Efficiency criterion: cost – benefit analysis				
Can be efficient or inefficient		Efficiency criterion may apply, but they must be refuted solely on the basis of economic freedom criterion		Can be efficient or inefficient

Table 1: Government actions and the two evaluation criteria

6. Conclusions

In this paper we have tried to answer the question of how to conceptualize economic freedom in a useful way when accepting the classical liberal notion that

²¹ Vanberg (2004:4) interprets this in the following way: Hayek meant “to say that we must distinguish between the issue of whether we consider particular policy measures as desirable or undesirable and the issue of whether they are compatible or, in principle, incompatible with a market order”.

some (kind of) government intervention is needed to maintain economic freedom. How and where should we draw the line separating those actions of the government that are the prerequisites of economic freedom from those that hurt it? Based on Hayek's statement that "[t]he rule of law provides the criterion which enables us to distinguish between those measures which are and those which are not compatible with a free system" (Hayek, 1960:222) we explicitly argued that the question of the extent of economic freedom is reduced to the question of *how* the government uses its coercive power. Thus, in this spirit, we put the rule of law in its Hayekian sense at the center of the conceptualization of economic freedom as a criterion to separate those coercive actions that are necessary for economic freedom (freedom-compatible coercive actions) from those that reduce it (freedom-non-compatible coercive actions). We think this distinction can help us give a better understanding of *how* and *why* economic growth is affected by economic freedom and by government actions in general.

A long-standing theoretical issue in growth economics is how to differentiate between level effects and growth effects of different variables including those of government intervention. In the neoclassical framework (Solow, 1956) there is no growth effect of government interventions, while in the new growth theory some parameters which are hypothesized as being set by the government may even have a long-term effect on growth (Jones, 2005; Barro, 1990). This question is also raised in the empirical literature on economic freedom and growth (e.g., De Haan and Sturm, 2000). We think our idea of using the concept of the rule of law to separate two kinds of coercive government actions is helpful in this respect and leads us to propose that the lack or bad "quality" of freedom-compatible coercive actions of the government is the most harmful because these actions can reduce the growth of income and not only its level. The reason behind this proposition, which we think deserves further research, is that freedom-compatible coercive actions of the government (e.g., protection of property rights, enforcement of contracts, etc.) create an environment which makes individual entrepreneurial acts possible: such an environment is what is needed in the first place for entrepreneurs to be able to discover and realize productive profit opportunities on the market (Kirzner, 1973).

Furthermore, the idea of separating freedom-compatible coercive actions from those that are incompatible with economic freedom may help formulate hypotheses concerning how institutions that are the results of various governmental actions co-evolve with economic development. As it was argued by Ludwig von Mises (1940[1998]) government intervention is a self-generating process, because one interventionist act will create an unexpected market reaction making the government conduct newer acts to cure it and so on. Here the question can be raised, what are those government acts that generate this spiral of ever further interventions and what are those acts that are needed to institutionalize the

market process. Recognizing that the market process, i.e., the discovery and realization of profit opportunities (Kirzner, 1973), is part of the process of economic development can lead to a new perspective on the institutional conditions of progress.

More precisely, the theoretical framework we have derived in this paper may serve as a building block in an entrepreneurial (market process) interpretation of the question of which institutions of economic freedom are the exogenous conditions of economic development and which are those that are endogenously determined by development. That is, our categorization of coercive government actions gives us principles for how to disaggregate or restructure an economic freedom index for an empirical investigation of the endogeneity problem in the development process.²² Following this argument further, a hypothesis suggested by our paper is the following. It is clearly the institutions resulting from the freedom-compatible government actions (e.g., secure property rights, enforcement of contract) that are the exogenous conditions of economic development, because, as suggested by a large literature (e.g., Acemoglu et al. 2001; Benson, 1999; Hayek, 1960) they are shaped by historical-cultural factors that are outside the process of development.

As opposed to this, freedom-non-compatible government actions are to a large extent the results of the development process itself: as countries get richer, they are more prone to apply measures that hurt freedom (e.g., transfers and subsidies), but they are also prone to eliminate some others (e.g., controls). As a result, what really differentiates between rich and poor countries, in terms of economic freedom, is not the extent of the freedom-non-compatible coercive actions they take, but the extent to which their governments behave in a freedom-compatible way.

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²² As argued in Section 1, the issue of the endogeneity of institutions and policies of economic freedom in the development process also represents a possible path for further research. See also Faria and Montesinos (2009).

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