Chapter 11

CHEERING FOR CAPITALISM*

Peter T. Leeson and Claudia R. Williamson

In 1974 Peter Berger published his important book *Pyramids of Sacrifice*. That book examines what Berger calls “political ethics and social change.” In particular, it considers the “ethical dilemmas of development.” As Berger described his project, it was “largely shaped by my experience in and my reflections about Latin America […] I tried very hard to be evenhanded as between capitalist and socialist models of development, arguing that both should be assessed in terms of a number of moral criteria I proposed” (1986, 12).

Berger’s assessment in *Pyramids of Sacrifice* was that capitalism has some advantages and some shortcomings. The same is true of socialism. Between the two modes of political–economic organization, there is no obvious choice. To satisfactorily deal with development, capitalist and socialist advocates alike must abandon adherence to extremes and forge a practical third way.

Twelve years later, Berger changed his position: “the empirical evidence led me step by step to my present position, which is that capitalism is the morally safer bet” (1986, 12). Yet the view Berger expressed in *Pyramids of Sacrifice* approximates one that many people still hold today. According to that view, capitalism’s effect on development is ambiguous and mixed. We should therefore be cautious and modest advocates of markets. Those who do not water down, qualify, and temper their praise for capitalism as an engine of development are “ideologues,” “dogmatists,” and “free-market fundamentalists.” They let wishful thinking cloud their sight of reality, which does not warrant cheering for capitalism.

* This chapter extends and uses material from Leeson, Peter T. 2010. “Two Cheers for Capitalism?” Society 47: 227–233 and Leeson, Peter T. 2008. “Escaping Poverty: Foreign Aid, Private Property, and Economic Development.” *Journal of Private Enterprise* 23: 39–64. Email: PLeeson@gmu.edu; Claudia-Williamson@utc.edu. Address: Department of Economics, George Mason University, MS 3G4, Fairfax, VA 22030, USA; University of Tennessee at Chattanooga, Gary W. Rollins College of Business, 615 McCallie Ave., Fletcher Hall, Chattanooga, TN 37403, USA.

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Berger's (1986) later book, *The Capitalist Revolution*, urges social scientists to not be "dogmatic," to generate falsifiable propositions, and to examine the evidence in light of those propositions. In that spirit, we empirically evaluate the popular view that cheering for capitalism is unwarranted. Our evaluative benchmark reflects the dual moral criteria for development that Berger identified in *Pyramids of Sacrifice*. The first of those criteria, which Berger calls the "calculus of pain," refers to the avoidance of human suffering. The second criterion, which he calls the "calculus of meaning," refers to respect for the values of individuals in the developing world.

Our empirical method is simple: we examine how the growth of capitalism over the last 40 years is associated with development across countries. The results are unequivocal: more capitalism means more development. Unless one objects to higher income, longer life expectancy, more education, and greater political freedom, there is no reason to be a milquetoast defender of capitalism. For that is what sprawling markets have meant for countries that embraced capitalism since 1980. Acknowledging this fact does not make one dogmatic; refusing to acknowledge it does. The strong, positive association between capitalism and development is among the few relationships in the social sciences that are abundantly clear. If wealth is better than poverty, life is better than death, knowledge is better than ignorance, and liberty is better than oppression, then capitalism deserves to be cheered.

Data and Empirical Approach

Our analysis considers the cross-country relationship between changes in capitalism over the period 1980–2018 and four development indicators at the end of the period. Those indicators are income per capita, life expectancy, average years of schooling, and democracy. We focus on them for three reasons. First, they reflect broad and basic aspects of human welfare regarded as core to development: wealth, health, education, and political freedom. Second, they comport with the development categories that we imagine Berger had in mind when laying out the criteria he identified in *Pyramids of Sacrifice*: avoidance of human suffering—hence the wealth and health indicators—and respect for the self-determination of the indigenous population—hence the education and political freedom indicators. Third, average income is positively correlated with nearly every positive development indicator one can think of (e.g., access to a clean water source) and negatively correlated with nearly every negative development indicator one can think of (e.g., infant mortality). Thus, once the relationship between capitalism and average income has been identified, so has the relationship between capitalism and most other development indicators one might be interested in.

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Our data on capitalism are from the Fraser Institute's Economic Freedom of the World Project (Gwartney et al. 2020). Fraser scores countries on five equally weighted categories related to government's role, size, and activeness in the economy. Those categories are: (1) *Size of government*, which considers the share of government's expenditures, the level of taxes, and the degree of state ownership in an economy. (2) *Legal system and property rights*, which measures the quality and effectiveness of a country's legal system, such as how independent its judiciary is, the impartiality of courts, military interference with the legal system, and how well government protects private property rights. (3) *Sound money*, which measures the extent of inflation and the freedom to own foreign currency domestically and abroad. (4) *Freedom to trade internationally*, which measures the extent of tariff and non-tariff trade barriers, international capital market controls, exchange rate regulation, or other regulations on the ability to trade internationally. Finally, (5) *Regulation*, which covers government control of credit markets, minimum wages, price controls, time to start a new business, the number of licenses, permits and other bureaucratic approvals involved with starting and operating a business, and restrictions on hiring and firing workers. Fraser uses the above categories to compose an overall index of capitalism, or "economic freedom," that ranges from 0 (completely unfree) to 10 (completely free). With these data, we measure the percent change in capitalism in each country between 1980 (or, if data are not available that early, for the closest year for which they are available) and 2018.

Our development-indicator data are from several sources. To measure income per capita in 2018, we collect data from Penn World Tables 10.0 (Feenstra et al. 2015) on population and expenditure-side real GDP at chained purchasing-power parities in 2017 US dollars. To measure life expectancy in 2018, we collect data from World Development Indicators (World Bank 2020) on the number of years that a newborn infant would live if prevailing patterns of mortality at the time of her birth were the same throughout her life. To measure years of schooling in 2010—the last year for which data are available—we collect data on average years of schooling among the population age 25 and older from Barro and Lee (2013). Finally, to measure democracy in 2018 we collect data from Polity5 (Marshall and Gurr 2020), which scores countries on a scale from 0 (least democracy) to 10 (most democracy) based on the competitiveness of political participation, the openness and competitiveness of executive recruitment, and constraints on the chief executive.

Get Out Your Pom-Poms

Using the above data, Figures 11.1–11.4 present the partial correlations across countries between growth of capitalism over the period 1980–2018 and log income per capita, life expectancy, average years of schooling, and

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democracy, respectively, at the end of that period, controlling for capitalism in 1980 (or the first year for which data are available if they are not available for 1980). The relationships Figures 11.1–11.4 depict are clear and uniform in conclusion: the larger a country's capitalist stride over the last 40 years, the higher its development.

The average capitalist stride between 1980 and 2018 was nearly 30 percentage points. That represents an approximately one standard deviation increase in capitalism (30.9 percentage points). Such were the capitalist strides of, for example, India, Taiwan, and New Zealand. In Figure 11.1, a one standard deviation increase in capitalism is associated with a 92.7% increase in log income per capita—the equivalent of moving from Lebanon to South Korea. In Figure 11.2, a one standard deviation increase in capitalism is associated with a 5.4-year increase life expectancy. In Figure 11.3, it is associated with a 2.2-year increase in average years of schooling. And in Figure 11.4, it is associated with a two-thirds standard deviation increase in democracy—the equivalent of moving from Haiti to the United States. These relationships are statistically significant at the 1% level. And the development improvements they suggest are impressive, equivalent to approximately 10% of average log income per capita, 7.4% of average life expectancy, 27% of average years of schooling, and 39% of average democracy, respectively. If significantly higher income, longer life expectancy, more education, and more democracy warrant cheering, so does the growth of capitalism.

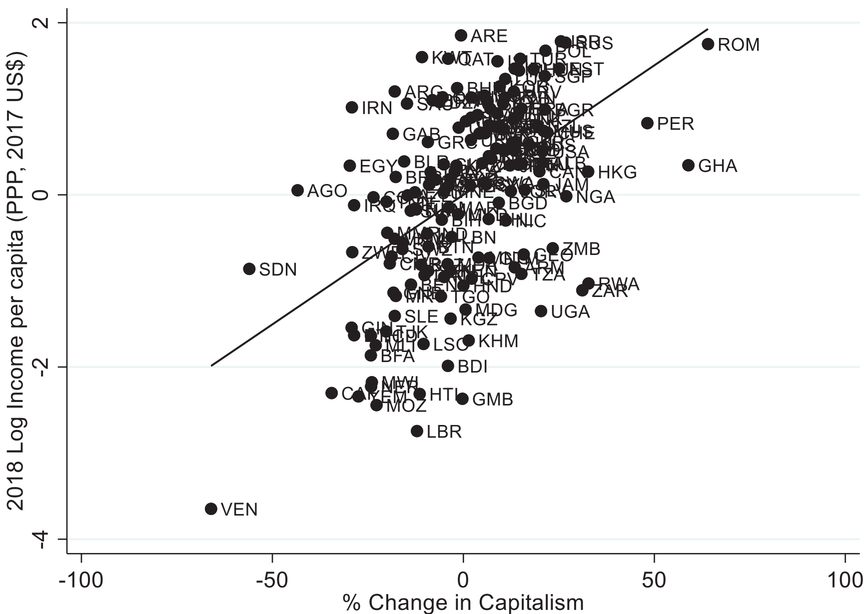

Figure 11.1. Growth of Capitalism and Log Income Per Capita.

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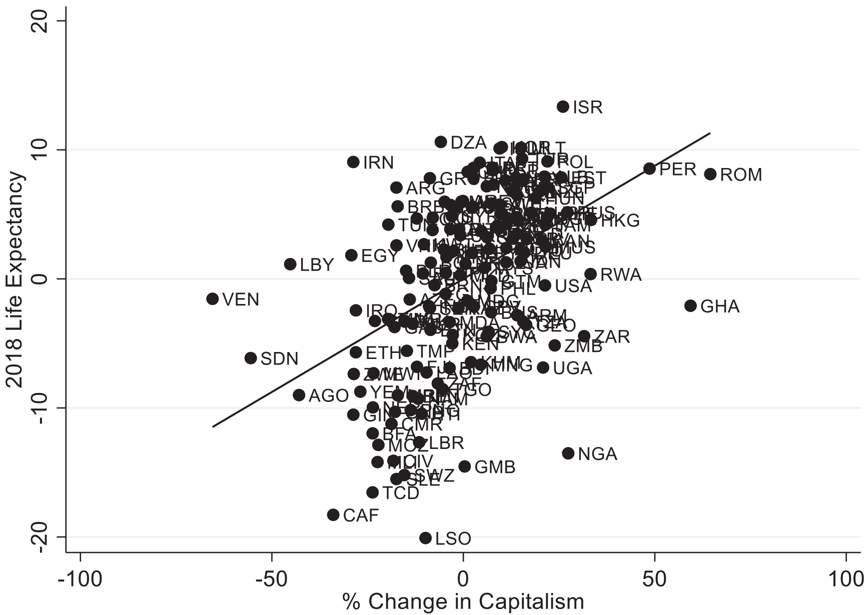

Figure 11.2. Growth of Capitalism and Life Expectancy.

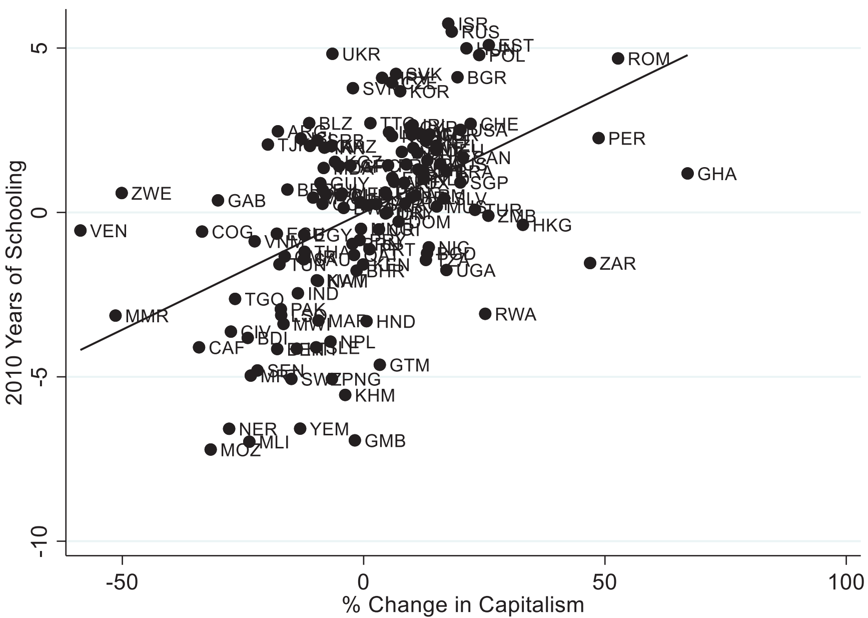

Figure 11.3. Growth of Capitalism and Average Years of Schooling.

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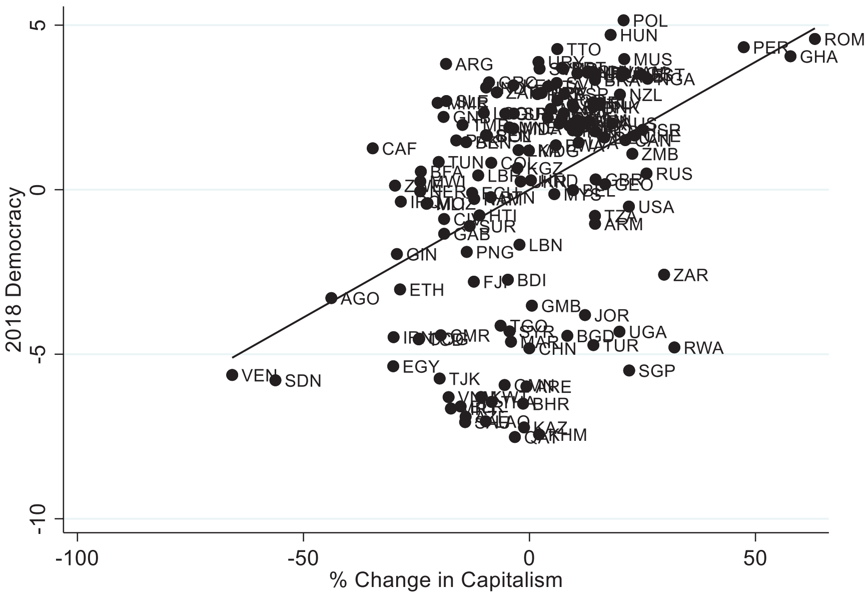

Figure 11.4. Growth of Capitalism and Democracy.

Why Capitalism Promotes Development

Just as the fact that capitalism promotes development is clear empirically, the reason it does so is clear theoretically: capitalism is a political–economic arrangement based on private property rights, and private property rights facilitate wealth creation. More wealth means the ability to invest in, for example, new medical technologies that increase life expectancy, additional educational facilities that increase years of schooling, and stronger safeguards on elections that increase democracy. In short, private property rights beget wealth, and wealth begets improvements in other areas of development.

The power of private property rights to facilitate wealth creation has two sources: the effect of private property rights on citizens' incentives to create wealth, and the effect of private property rights on citizens' ability to learn information required to create wealth. The former effect was identified by Adam Smith ([1776] 1904), who in the eighteenth century offered the first systematic inquiry into the nature and causes of the wealth of nations in his book bearing that title. Private property rights confer residual claimant status on resource owners: when the value of a resource rises, the increase accrues to its owner; when its value falls, the reduction falls on him. In the context of markets, this implies that to maximize his personal wealth, an owner must use

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his resources in a way that maximizes their value to society. Hence, Smith's "invisible hand," according to which, in an institutional environment of private property rights, private pursuits produce public benefits. By interconnecting the interests of disparate individuals in this way, private property rights provide powerful incentives for individuals to create wealth.

The effect of private property rights on citizens' ability to learn information required to create wealth was identified by Ludwig von Mises in the early twentieth century. While studying the comparative abilities of capitalism and socialism to create wealth, Mises ([1920] 1990) made a revelatory discovery. Wealth creation requires rational resource allocation—that resources be channeled to uses where their social value is higher rather than lower. The only way to reliably learn whether resources have been channeled in such a fashion is through economic calculation: through the tabulation of profits, which suggest that the resource uses created wealth, and through the tabulation of losses, which suggest that the resource uses destroyed wealth. Economic calculation, however, requires market prices on the basis of which profits and losses can be tabulated. And market prices require exchange; for such prices are but exchange ratios that emerge from market trades. Market exchange, finally, requires private property rights because resources cannot be exchanged in markets unless resources have private owners. Private property rights, therefore, are the institutional prerequisite of economic calculation, without which the information required to allocate resources rationally—to create wealth—is impossible to learn.

Mises' student F.A. Hayek (1945) built on his teacher's discovery by elaborating the informational role of market prices. Market prices, Hayek observed, communicate to producers and consumers the relative scarcity of resources. They inform producers how to combine resources in ways that produce maximal value for consumers, and they inform consumers when a change in economic circumstances counsels an expansion or contraction of particular goods consumed. That information is not accessible apart from market prices because the knowledge on which it is based is diffused across the members of society, each of whom operates in the particular circumstance of her own time and place, usually in ignorance of the particular circumstances of other individuals' times and places. By making market exchange and prices possible, private property rights thus make it possible to access the information required to coordinate resource use in a way that creates wealth rather than destroys it.

Taken together, the information-creating and incentive-harnessing capacities of private property rights furnish the economic logic behind why capitalism promotes development. On the one hand, to create wealth,

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individuals need a way of learning what will create wealth. And on the other hand, once individuals know that, they need inducement to follow through on what is learned. Private property rights satisfy both needs, thereby assuring the creation of wealth that can be used to improve development more broadly.

Capitalism, recall, is a political–economic arrangement based on private property rights. What, then, is government's role in all this?—to protect citizens' private property rights, which mostly involves refraining from attenuating those rights through regulations, confiscatory taxes or (what is nearly the same) high inflation, and outright expropriation. Adam Smith understood this already in the eighteenth century. As he put it, "Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things" (Smith [1776] 1904: I.56).[†] After securing citizens' private property rights, government's best course of action for promoting development is thus merely to avoid interfering with "the natural course of things."

Insofar as government does not avoid such interference, it threatens to retard wealth creation, hence development more broadly. The logic is just the reverse of that which explains why private property rights and therefore capitalism promote development. First, government interventions that attenuate private property rights weaken and/or distort citizens' incentives to create wealth. High taxes, for example, weaken those incentives by weakening owners' status as residual claimants. And regulations make unproductive avenues of economic activity, such as seeking regulatory protection from market competitors, more profitable, and make productive avenues of economic activity, such as seeking better ways to satisfy consumer wants, less profitable. The resulting distortion of incentives undermines wealth creation on two fronts. On the one hand, valuable resources are expended currying political favor instead of producing socially valuable output. And on the other hand, the political favor sought is often the creation of a privilege such as a monopoly grant that—even if no resources had to be expended to procure it—would inhibit rather than facilitate wealth creation.

Second, government interventions that attenuate private property rights distort the information embodied in market prices, which undermines citizens' ability to learn information required to create wealth. Some interventions, such as wage and price controls, interfere with market prices directly, thereby blocking the generation of information required for rational resource allocation. Other interventions, such as subsidies or import barriers, interfere

† This quote is originally attributed to Smith in 1755.

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with market prices indirectly but have a similar effect. Consider, for example, a domestic industry protected from more productive foreign competitors by a tariff. Because of the tariff, production in the protected industry will appear to be more profitable than is justified by its actual contribution to wealth. Hence, resources will be attracted to that industry despite the fact they have more valuable uses elsewhere in the economy. By the same token, production in unprotected industries that would attract resources drawn to the protected industry if that industry were not protected by the tariff will appear to be less profitable than is justified by its actual contribution to wealth. Hence, resources will be repelled from unprotected industries despite the fact that their most valuable uses are in those industries. In both cases, information required to create wealth is distorted, undermining wealth creation.

In countries that have embraced capitalism more fully, government provides better protection for citizens' property rights. But that protection is largely from government itself and mostly takes the form of less state intervention in economic affairs. Less intervention allows the incentive-harnessing and information-creating capacities of private property rights to operate with less distortion. In doing so, less intervention does more to enable—or rather, does less to disable—wealth creation, which in turn permits development improvements in other areas.

The Jury Is Not Out

One of us attended a conference some years ago at which, after spirited discussion about the merits of capitalism for development, a conference participant who feared the praise for capitalism was growing unduly strong on one side of the room remarked that

> The jury is still out on how capitalism has affected development globally. Capitalism has brought some benefits for certain countries. But we can't make blanket statements about capitalism's 'goodness' for development. We simply don't have the evidence we need to make a judgment on that question, and what little evidence we do have is less than clear.

She offered this remark to her colleagues' approving nods. We have subsequently heard others make similar claims, which reflect classic cheering-for-capitalism-is-unwarranted thinking.

Contrary to the conference participant's assertion, the jury is not still out on how capitalism affects development globally. The jurors returned long ago, and all of them who looked at the evidence returned the same verdict: capitalism improves development. We considered a piece of that evidence by

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examining how the growth of capitalism is associated with development. Far from ambiguous, the results are clear to the point of smacking one in the face: the larger a country's capitalist stride over the last 40 years, the higher its development. Increased capitalism is associated with higher income per capita, longer life expectancy, more years of schooling, and more democracy. Capitalism is not just the "safer bet" for development, as Berger ultimately concluded. It is the only bet that makes any sense at all. Capitalism deserves our cheers. It is time that we give them.

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