Are We All Capitalists Now?

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According to conventional wisdom, collectivism has been vanquished in all but a few infirm nations, and hence long-run economic prospects are far brighter for most of the world. The *Wall Street Journal* rejoices: "Capitalism is triumphant. Market forces have spread to every corner of the globe. National boundaries seem to be dissolving" (Wessel and Harwood 1998). A recent book by the distinguished economist and former U.S. Treasury official Paul Craig Roberts and Karen LaFollette Araujo, *The Capitalist Revolution in Latin America* (1997), also exudes optimism about capitalism's prospects. Yet free-market momentum has slowed because of the global financial crisis, widely publicized economic troubles in transitional economies, the electoral success of the Left in Europe and elsewhere, and similar events. Multilateral institutions based on the presupposition of market failure, such as the International Monetary Fund, have expanded their roles in coping with global economic problems, to the disappointment and consternation of pro-market politicians, economists, and pundits.

Are the free-market reforms of recent times secure? Are they vulnerable to reversal? These are urgent questions, although admittedly hard ones to answer, given the diversity of local politics throughout the world. It is regrettable that journalistic and other impressionistic, albeit expert, commentary dominates public discourse on these questions. A comprehensive but succinct summary of the state of economic liberalism around the world at the height of the reform movement would be helpful as we assess the vitality of the fledgling world order. Quantitative indexes of the international commitment to Smithian policies would shed light on the collective ideological mood, about which only piecemeal impressions currently exist.

The means with which to make a quantitative assessment are available in the numerical ratings of economic freedom published by the Heritage Foundation

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(Johnson and Sheehy 1996), the Fraser Institute (Gwartney and Lawson 1997), and Freedom House (Messick and Kimura 1996). These new indexes permit the extent of diversity in economic regimes in the modern world to be described with great precision and, I believe, with enough accuracy for present purposes. In the light of this evidence, the world's commitment to economic liberalism appears more tenuous than is commonly believed.

The methodologies of the Heritage Foundation, Fraser Institute, and Freedom House studies have been compared in a valuable survey by Hanke and Walters (1997), whose article may be consulted for details. Hanke and Walters have shown not only that all three indexes are thoughtfully and meticulously prepared but also that, despite their differences, they are highly correlated with one another. For the purposes of this essay, I need only mention some basic information and make a few supplemental observations on the approaches and methodologies of the indexes.

The Indexes

To measure economic liberty, the Heritage and Fraser reports concentrate on official economic policy and practice. Equating economic liberty with procapitalist policies, their implicit standards of evaluation most closely resemble those of a foreign investor. Freedom House takes a legalistic approach, defining economic freedom in terms of an individual's constitutional right to undertake certain activities, such as owning a business or engaging in foreign trade, regardless of the official policies of the moment. Although an independent scholar, Gerald Scully (1992), employed a slightly different approach in his valuable study of economic growth under various constitutional regimes during the 1980s, the Heritage, Fraser, and Freedom House indexes represent the current frontiers of the field.

The Heritage index, which is cosponsored by the *Wall Street Journal* and is influential in official Washington, compresses into a single number its assessments of local conditions in ten areas of economic life: official trade policy, taxes, government consumption of output, monetary policy, foreign investment policy, banking policy, wage and price controls, property rights, economic regulation, and black market activity. Conditions in each area are rated on a 1–5 scale, with 1 standing for the most economic freedom and 5 for the least, on an idealized spectrum representing the business or investment climate. These numbers in turn are combined into an unweighted average, which is the summary index for each country.

The Fraser methodology arranges seventeen areas of economic life under four headings: money and inflation, government operations and regulations, takings and discriminatory taxation, and restraints on international exchange. Fraser's seventeen categories are in most respects an elaborate version of Heritage's ten, but they are explained and defended in more rigorous theoretical terms. The Fraser study places the data for each topic on a 10–0 scale running in the opposite direction from the Heritage scale, with 10 representing the most economic freedom and 0 the least.

Country coverage is another important difference between the two studies, attributable in part to differences in their purposes. The Fraser index, intended for academic uses, is historically oriented, presenting measurements between 1975 and 1995 at five-year intervals. It covers as many as 115 countries, depending on the availability of historical data. The first volume of the Heritage index appeared in 1995; new and expanded sets of estimates are published each year. Heritage covers more of the developing world than Fraser does. Although the two studies have only 1995 in common, I have chosen to use the 1996 edition of the Heritage index for the sake of comparability and because of its expanded coverage. The inevitable delays of data collection and processing mean that it likely reflects 1995 conditions better than the original Heritage index, which presumably incorporates at least some pre-1995 data. The simple correlation coefficient between the 1995 and 1996 Heritage indexes is 0.96. The 1997 Fraser study is an improved and expanded version of Fraser's 1996 study, not a serial edition, but using either makes no difference.

Freedom House, the leading authority on political freedom and civil liberties in the world, recently expanded its scope to include the measurement of economic freedom. It shares with the Heritage Foundation, the Fraser Institute, and most economists a firm belief in the salutary effect of economic freedom on economic performance, but its definition of economic liberty flows from its own philosophical tradition and departs from custom among professional economists. Freedom House concentrates on the constitutional situation, distinguishing between economic freedom and normal economic policy, although it concedes that the two may intersect. Freedom House's main indicators are the freedom to hold property, to earn a living, to operate a business, to invest one's earnings, to trade internationally, and to participate in the market economy. Each of these categories includes a number of secondary criteria, such as the presence or absence of intellectual property rights, legal discrimination against women and children, and a right of voluntary association for economic purposes such as wage bargaining. The rating scale runs from 0 (not free) to 16 (free). A country's score is the sum of scores on each of the six main criteria listed previously. The scale for each score is 0–3 in most cases, but 0–2 in some.

Freedom House's iconoclasm is illustrated by the case of Singapore, which has a low tax rate, a small share of national output consumed by government, and liberal policies toward foreign investment—preeminent hallmarks of economic liberty from the Heritage and Fraser points of view. Freedom House, however, rates Singapore only "partly free," because of its strict controls of trade unions, the lack of official neutrality in competition between public and private companies, and its official refusal to recognize business ownership as a right rather than a privilege.

The country coverage also is narrower in the Freedom House study than in the Heritage and Fraser studies, amounting to only eighty-two countries. Those seem to have been chosen because of their prominence or importance in the world: Freedom House remarks that they represent 90 percent of world population and 99 percent of global output of goods and services. Industrial countries, representing about a quarter of the sample, bulk larger than in the other samples. Furthermore, if Freedom House is correct to assert that higher incomes accompany economic freedom, the rest of the sample is likely to be biased toward economically free countries as well. The summary statistics calculated from the Heritage and Fraser samples move a little toward the free-market end of the scale when those samples are matched to the Freedom House sample. Thus, even if Freedom House's definition of economic freedom is accepted, summary statistics from the Freedom House study almost certainly overstate the extent of global economic freedom.

Findings

Means, medians, and coefficients of variation for the Heritage, Fraser, and Freedom House indexes are presented in unweighted (strictly speaking, country-weighted) and population-weighted forms in table 1.[1] The table also includes subcategories of the data. The subcategories match those used in the Fraser study; I assigned countries from the other studies according to Fraser's obvious logic of classification. Former Soviet republics are classified separately. The Heritage Foundation identifies a rating of 3 on the 1–5 scale as the boundary between, in its terminology, mostly economically free and mostly economically unfree. The comparable point on the 10–0 Fraser scale would be 5 and on the Freedom House scale, 8.

The top line in each panel contains the summary statistics for the samples and subsamples (the sizes of which appear in parentheses) covered in each study. According to the unweighted means and medians, the typical country in panels A and B hovers around the middle of the scale, diverging little in either direction. In neither case does the typical country seem dedicated to free enterprise. Notice that the full-sample Heritage results tilt to the illiberal side and the Fraser results to the liberal side. These distributions both appear to be statistically normal, according to standard tests, which is another interesting discovery,[2] but the centering of the distributions near the midpoints of these arbitrary scales appears coincidental. The Fraser data for 1985 (not shown) are centered to the left of both the scale's midpoint and the 1995 results, corroborating the common perception of a general trend toward economic reform in the recent past.

The population-weighted results, which describe economic regimes in terms of the number of people within their jurisdiction, are more revealing. As shown in panels A and B of the table, the weighting procedure causes the summary measures to move

1. The population data are taken from World Bank (1997) and occasionally supplemented with estimates from United Nations Development Programme (1995).

2. The Shapiro-Francia test and the test developed by D'Agostino, Balanger, and D'Agostino (1990) were used.

Table 1: Summary Statistics for Heritage, Fraser, and Freedom House Indexes

	Unweighted			Weighted		
	(1) Mean	(2) Median	(3) Coefficient of Variation	(4) Mean	(5) Median	(6) Coefficient of Variation
A. Heritage Index						
All (142)	3.10	3.05	0.25	3.34	3.65	0.21
Asia (22)	3.15	3.08	0.33	3.61	3.75	0.14
Africa (35)	3.43	3.40	0.14	3.43	3.25	0.13
Latin America (27)	3.08	3.00	0.20	3.26	3.35	0.13
Europe/ Middle East (27)	3.17	2.95	0.25	3.53	3.45	0.22
Former Soviet (11)	3.55	3.50	0.16	3.64	3.50	0.09
Industrial (20)	2.14	2.08	0.13	2.10	2.05	0.13
B. Fraser Index						
All (115)	5.27	5.50	0.27	4.92	4.40	0.26
Asia (15)	6.10	6.30	0.26	4.70	4.40	0.19
Africa (30)	4.21	4.15	0.24	3.91	3.90	0.26
Latin America (24)	5.80	6.15	0.18	5.11	5.50	0.24
Europe/ Middle East (20)	4.59	4.75	0.26	4.03	4.10	0.22
Former Soviet (6)	4.42	4.25	0.22	3.54	3.50	0.10
Industrial (20)	6.55	6.45	0.15	6.93	6.70	0.12
C. Freedom House Index						
All (82)	9.84	11.00	0.47	7.49	7.00	0.62
Asia (15)	7.00	7.00	0.58	5.19	6.00	0.61
Africa (8)	8.25	8.00	0.46	6.61	4.00	0.58
Latin America (13)	9.38	10.00	0.38	8.71	8.00	0.33
Europe/ Middle East (16)	9.25	10.50	0.47	8.21	8.00	0.52
Former Soviet (11)	7.18	7.00	0.61	6.52	7.00	0.34
Industrial (19)	14.95	15.00	0.06	14.95	15.00	0.08

toward economic illiberalism. The hypothesis of statistical normality is rejected for the weighted Heritage distribution, although not for the corresponding Fraser distribution. The population-weighted distribution is skewed dramatically. About 43 percent of the world's population live under regimes rated between 3.7 and 4.0 on the Heritage scale. Omission of the industrial countries changes that figure to 49 percent. The weighted distribution in particular implies the absence of a definitive break with collectivist ideology.

The specific country groupings in the rest of table 1 provide more food for thought. Two broad similarities between the top two panels deserve particular attention. First, population weighting challenges perceptions of the demise of collectivism or statism even more emphatically than does country weighting. The general conclusions reached above do not pertain just to localized circumstances or atypical cases, such as extraordinarily populous India and China, countries that for statistical purposes are classified in the same region. Second, the differences between the estimates for the industrialized countries and the rest are large in both panels. Weighting the estimates sharpens the distinction between the industrial category and the others: estimated economic liberty actually drifts toward the "free" extreme for the rich countries. This comparison is enlightening because industrial countries impose on themselves many laws, regulations, and social programs that restrict their output of goods and services; they are hardly free-enterprise countries in an absolute sense. That most of the world compares poorly to such countries reveals that alternative systems remain deeply entrenched.

Perhaps that point is moot, given the speed of economic reform around the world. The Fraser estimates provide a preliminary basis for assessing the world rate of reform. Between 1985 and 1995 the unweighted median of the Fraser estimates rose from 4.1 to 5.3 and the weighted median from 3.6 to 4.4. For nonindustrial countries the comparable figures are 4.1 and 4.8 for the unweighted estimates and 3.4 and 4.5 for the weighted ones. The trend of the various means is approximately the same. If we treat the numbers for the nonindustrial countries as representing a rate of shift of roughly 25 to 30 percent per decade in the center of the distributions, then in 2005 the nonindustrial countries should average in the vicinity of 5.5 or 6.0 on the Fraser scale, or substantially below the level of today's industrial countries. This admittedly rough approximation indicates that not even a simple and presumably rosy extrapolation of recent history, by most accounts an exceptionally favorable period for economic reform, implies a comprehensive commitment to free-market economic policies in the nonindustrial world in the near future.

Panel C of the table contains the summary statistics for the Freedom House index. According to the unweighted results on the top line, the typical country comes closer to free markets—8 is the scale's midpoint—especially if the median is taken to be the better measure of central tendency. The bias in the Freedom House sample, however, makes it hard to view these findings as contrary to those based on the Heritage and Fraser indexes. This point is reinforced by the population-weighted results, for which the summary statistics fall short of the midpoint of Freedom House's scale. It is not likely that inclusion of the omitted countries would make economic freedom in the constitutional sense seem normal for most of the world's population.

The rest of panel C embellishes and, on the whole, supports these inferences. The industrial countries, for which the weighted and unweighted results are identical, are head and shoulders above the rest in economic freedom, especially in the weighted estimates. They also are similar to each other, as evidenced by the tiny coefficients of variation in columns 3 and 6. The statistics in panel C, however, do not strictly contradict the analogous ones in the other panels. Notice, too, that the continent of Africa is underweighted in the total Freedom House sample. Africa is reputed to be an economically illiberal region for the most part, so that inclusion of more African countries (including North Africa) likely would create an even gloomier picture of economic freedom in the world.

In light of the philosophical and methodological differences between Freedom House, on one hand, and the Heritage Foundation and the Fraser Institute, on the other, the correlation of the Freedom House estimates with the others is also of interest. The simple correlation coefficients for identical samples are –0.78 and 0.66, respectively, for Heritage and Fraser. Both coefficients are statistically significant, and they have the same meaning despite their opposite signs. The weighted correlation coefficients are about the same. The lower correlation coefficient (in absolute value) between the Freedom House and Fraser estimates is not surprising, given the distinct theoretical and methodological contrasts. Still, these coefficients are greater than might have been expected. They imply a direct association between capitalistic economic policies and economic rights. The coefficients drop, however, if the industrial countries are removed from the samples. In that case, they become –0.66 and 0.54, respectively—again, both are statistically significant—for the unweighted estimates. For the weighted estimates they are –0.59 and 0.43, indicating that the Freedom House estimates continue to track the others, albeit less closely.

A more striking difference lies in the high variability of the Freedom House estimates, as revealed by the coefficient of variation. For most regions or classifications of countries the dissimilarities among the Freedom House estimates exceed the dissimilarities among the other estimates by a large margin. A more rigorous comparison obtained by matching the three samples (68 countries) yields coefficients of variation of 0.34, 0.25, and 0.25 for Freedom House, the Heritage Foundation, and the Fraser Institute, respectively, a less striking difference. But matching Freedom House and the Heritage Foundation samples (77 countries) produces coefficients of variation of 0.45 and 0.29, again markedly different.

Taken at face value these comparisons imply that international differences in economic policy regimes tend to be smaller than differences in economic rights. Among conceivable explanations of these findings, one possibility is particularly tantalizing. Perhaps international agreement is greater on economic policy or the need for a good business climate, especially for foreign investors, than on the desirability of a liberal legal environment or extensive economic rights for the domestic population. The middling correlation coefficients between Freedom House and each of the other indexes just described for the nonindustrial world are consistent with this conjecture. It is arguable, furthermore, that competitive forces would produce greater convergence of policies affecting foreign capital than of freedoms accorded domestic citizens, the latter being less salient abroad and more closely linked to local politics, history, and culture.

Conclusion

The three ambitious studies summarized in this article all disclose that even before the start of the global financial crisis of the late 1990s the revealed preferences of nations raised doubts about assertions of capitalism's global ascendancy. Commitment to the market throughout most of the world was half-hearted at best, notwithstanding widespread impressions to the contrary. A reversal of liberal reforms in some places therefore should come as no surprise. The process, in fact, may already have begun. The Heritage Foundation describes 1998 as a year in which economic freedom receded in the world (Johnson, Holmes, and Kirkpatrick 1999). To be sure, old-style collectivism has few forthright defenders in today's world. Secular trends in world opinion favor the market and economic freedom, however defined, and many procapitalist regimes exist. Yet the key fact is the timidity with which capitalism has been embraced in most places, leaving the new world capitalist order highly vulnerable to attack by its recently rejuvenated enemies.

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