

Liberal Ideas Capital and Asset Pricing: A Political Economy of Risk, Return, and Freedom

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Abstract

We develop a new theory of asset pricing based on the concept of liberal ideas capital—a stock of intangible, ideational resources rooted in human dignity, individual liberty, free speech, constitutional democracy, property rights, and the rule of law. Building upon the philosophical foundations of John Locke, Thomas Jefferson, Alexis de Tocqueville, Lord Acton, Ludwig von Mises, Friedrich Hayek, and Milton Friedman, and integrating recent contributions by McCloskey, Phelps, and Heng-Fu Zou, we construct a dynamic general equilibrium model in which liberal ideas capital plays a central role in driving productivity, institutional stability, and investor confidence. In this framework, countries that invest in and accumulate liberal ideas capital experience lower transaction costs, more secure property rights, higher innovation, and thus, superior asset returns and lower volatility over time. Empirically, we assemble cross-country data on liberalism-related indices—freedom of speech, property rights, rule of law, press freedom, and democratic governance—and demonstrate that nations with higher levels of liberal ideas capital exhibit systematically higher long-term equity returns and stronger economic performance. In contrast, countries dominated by authoritarian ideas capital exhibit persistent institutional fragility, lower risk-adjusted returns, and weaker investor protection. Our findings challenge conventional asset pricing models by revealing the deep ideational foundations of market behavior. We argue that liberal ideas form the cognitive and institutional prerequisite for asset pricing itself, making price discovery and risk assessment possible. This elevates the intergenerational transmission of these norms—a process of "soulcraft"—to the most critical form of capital investment for ensuring long-run financial stability and prosperity. The paper thus offers a unified theory of political economy, ideology, and finance, concluding that a society's most valuable asset is the shared belief in liberty.

Keywords: Liberal ideas capital; asset pricing; political economy; ideology; freedom indices; constitutional democracy; property rights; human dignity; institutional economics; economic development; capital markets; authoritarianism; transaction costs.

1 Introduction

Over the past three centuries, the world has witnessed an extraordinary transformation in human prosperity that defies conventional economic explanation. This "Great Enrichment", to use Deirdre McCloskey's evocative term, represents not merely an incremental improvement in living standards but a revolutionary thirty-fold increase in real income per capita in the countries that fully embraced it. The magnitude of this change is historically unprecedented: after millennia of near-stagnation where the average person lived on the equivalent of \$3 a day, suddenly—beginning around 1800 in Northwestern Europe—ordinary people began to experience sustained improvements in their material conditions that would have seemed miraculous to their ancestors.

Mainstream economic theories have long acknowledged the role of institutions in promoting development and securing property rights (North 1990; Acemoglu and Robinson 2012), but they often treat institutions as exogenous or as policy variables manipulable by governments. In contrast, this paper proposes that institutions themselves are the consequence of deeper ideological commitments embedded in society. In other words, before there can be a constitution, there must be a shared belief in constitutionalism; before markets function efficiently, there must be widespread adherence to ideas of liberty, non-aggression, and property rights (Zou, 2024). These ideational commitments form what we call liberal ideas capital—a dynamic stock of moral, political, and philosophical beliefs that enable institutions to emerge, function, and evolve.

This framework builds on a growing body of literature that re-centers ideas in the study of economics and finance. McCloskey (2010, 2016, 2020) has argued persuasively that the rise of dignity, individual responsibility, creativity, and freedom was the cultural root of the modern economic miracle. Edmund Phelps (2013) has similarly emphasized the role of "mass flourishing" driven by a society's commitment to innovation, autonomy, and openness. Complementing these cultural accounts, Fukuyama (2022) has explored the moral and institutional fragility of liberalism in the face of populist or authoritarian alternatives, reinforcing the notion that liberalism is not a self-sustaining equilibrium but a historically contingent achievement. Our contribution is to formalize these insights in a rigorous dynamic asset pricing model, treating liberal ideas capital as both a stock variable and a productive input.

In contrast to institutional-based asset pricing models (Zou 2025a, 2025b), this paper shifts the analytical foundation one step earlier in the causal chain. Liberal ideas capital determines the institutional environment, which in turn influences asset prices, returns, volatility, and growth potential. For example, countries with stronger stocks of liberal ideas capital—those that secure property rights, protect press freedom, and allow the contestation of political power—tend to enjoy deeper capital markets, higher long-run returns, and greater macroeconomic stability. Conversely, regimes where authoritarian ideas dominate—emphasizing obedience, repression, and centralized control—suffer from low innovation, shallow financial development, capital flight, and valuation collapses. These patterns are not anomalies; they are the empirical shadows cast

by divergent stocks of liberal and authoritarian ideas capital.

A defining feature of liberal ideas capital is its investability. It requires sustained effort to accumulate and maintain. Educational systems that foster critical thinking, legal frameworks that reward dissent, open forums for public deliberation, constitutional safeguards for individual rights, and media pluralism—all function as channels of liberal idea formation and dissemination. Like physical capital, liberal ideas capital depreciates when neglected. Repression, censorship, ideological indoctrination, and the concentration of power erode liberal ideas capital and make societies vulnerable to authoritarian regression. Just as we model human capital with accumulation equations, so too must we model liberal ideas capital—with investment, depreciation, external shocks, and inter-generational transmission.

The key innovation of this paper is the integration of liberal ideas capital into a formal asset pricing framework. We construct a dynamic model in which a representative agent maximizes utility not only from consumption but also from the evolving stock of liberal ideas capital. The production function includes liberal ideas capital as a complementary input alongside traditional capital. Asset prices are then derived from the present value of future output flows, adjusted for the endogenous evolution of liberal ideas capital. This approach allows us to explain variations in cross-country returns, volatility, and market depth as a function of liberal ideological investment and decay. In this way, we offer a new channel through which cultural and political ideas manifest in measurable economic quantities.

To validate the predictions of our theoretical framework, we conduct a comprehensive empirical analysis using a newly constructed panel dataset that merges premier cross-national data on institutional quality, financial performance, and macroeconomic controls. We measure a country’s stock of liberal ideas capital using the Varieties of Democracy (V-Dem) project’s Liberal Democracy Index, a comprehensive metric that aligns closely with our theoretical construct. Financial performance is measured by long-run equity market returns, sourced primarily from the World Bank’s Global Financial Development Database. Our multi-pronged empirical strategy first establishes a causal link in a sample of OECD countries, where data quality is highest, using a stringent two-way fixed-effects model. We then extend the analysis to Latin America and Sub-Saharan Africa, employing comparative group analyses and case studies to navigate data limitations while leveraging the rich cross-sectional variation in these regions.

The empirical findings offer robust support for our theory. For OECD economies, we find that improvements in the Liberal Democracy Index have a statistically and economically significant positive effect on future long-run equity returns, even after controlling for a host of standard economic determinants. This confirms that liberal ideas capital is a priced factor in developed markets. In Latin America and Sub-Saharan Africa, our comparative analysis reveals a stark divergence in outcomes: countries with a higher stock of liberal ideas capital systematically develop financial markets that are substantially larger, deeper, and markedly less volatile. While raw returns in institutionally weaker

countries are sometimes higher, this reflects a significant premium for extreme political and economic risks; their risk-adjusted returns are either inferior or, at best, indistinguishable from those of their more stable peers. Taken together, the evidence from across diverse global settings confirms that liberal ideas capital is not a mere rhetorical flourish but a quantifiable and fundamental driver of sustainable, risk-adjusted financial prosperity.

Our approach is deeply rooted in the Western liberal intellectual tradition. Thinkers such as John Locke, Thomas Jefferson, Alexis de Tocqueville, Lord Acton, Ludwig von Mises, Friedrich Hayek, and Milton Friedman advanced ideas that gave birth to constitutional democracy, private property rights, market economies, and legal equality. These ideas were not just normative aspirations; they were functional innovations that unlocked productive cooperation and decentralized decision-making on an unprecedented scale. By translating their insights into a rigorous macro-financial model, this paper reclaims political economy from the sterile abstraction of apolitical models and reaffirms that ideas matter—not just morally or historically, but analytically and quantitatively.

In summary, this paper makes three major contributions. First, it redefines capital to include liberal ideas capital as a dynamic, productive stock. Second, it constructs a rigorous asset pricing model that integrates liberal ideas capital into the production and valuation process. Third, it provides empirical support for the causal role of liberal ideas in determining long-run financial and macroeconomic outcomes. In doing so, we seek to restore the name and spirit of political economy to modern economics, reaffirming that the deepest determinants of prosperity and asset returns are not material or institutional, but ideological.

The remainder of this paper is structured as follows. Chapter 2 presents the formal model setup and the accumulation dynamics of liberal ideas capital. Chapter 3 derives the model's equilibrium conditions and its core asset pricing implications. Chapter 4 provides the comprehensive empirical evidence supporting our theory. Building on these findings, Chapter 5 delves into the deeper cognitive and institutional foundations of asset pricing, explaining how liberal ideas shape the very possibility of market functions like price discovery and risk assessment. Chapter 6 elevates this discussion, issuing an urgent call for "inter-generational soulcraft" and arguing that the cultivation of liberal capital is the most critical form of investment for a prosperous and free society. Chapter 7 concludes.

2 Model Setup and Liberal Ideas Capital Accumulation

We consider a continuous-time, infinite-horizon endowment economy populated by a representative agent who derives utility not only from consumption $c(t)$, but also from the stock of liberal ideas capital $L(t)$, which embodies the societal infrastructure of liberty, dignity, innovation, and institutional trust. This

includes the rule of law, protection of private property, freedom of contract, open competition, and individual rights. The agent maximizes lifetime utility according to a recursive CRRA specification with direct preferences over both consumption and liberal capital:

$$U = \mathbb{E}_0 \left[\int_0^\infty e^{-\rho t} \cdot u(c(t), L(t)) dt \right], \quad \text{where} \quad u(c, L) = \frac{[c(t)L(t)^\psi]^{1-\gamma}}{1-\gamma},$$

with $\rho > 0$ as the subjective discount rate, $\gamma > 0$ the coefficient of relative risk aversion, and $\psi > 0$ measuring the utility weight effect of liberal capital.

Output in this economy arises from a neoclassical Cobb–Douglas production function augmented to include liberal ideas capital. We assume that total output is produced by a fixed quantity of physical capital K , combined with a growing stock of liberal capital $L(t)$:

$$Y(t) = AK^\alpha L(t)^{1-\alpha}, \quad 0 < \alpha < 1,$$

where $A > 0$ is a constant productivity term, and liberal capital plays a role both in production and in generating social infrastructure and institutional trust.

The agent allocates output between two uses: consumption $c(t)$ and liberal capital investment $i_L(t)$. Physical capital is assumed constant in this framework to isolate the effects of liberal capital accumulation on asset pricing. Thus, the resource constraint is:

$$c(t) + i_L(t) = Y(t) = AK^\alpha L(t)^{1-\alpha}.$$

Liberal ideas capital evolves according to the following stochastic differential equation:

$$dL(t) = [i_L(t) - \delta_L L(t)] dt + \sigma_L L(t) dW_t,$$

where $\delta_L > 0$ is the depreciation rate of liberal capital (reflecting erosion of rights), $\sigma_L > 0$ measures the volatility of liberal capital due to political shocks, ideological backsliding, or repression, and W_t is a standard Brownian motion capturing such uncertainty. This formulation allows us to model the collapse or fragility of liberal norms in autocratic transitions, as well as the stabilization of liberal rights under constitutional democracy.

Substituting the budget constraint into the dynamic law of motion, we obtain the evolution of liberal capital as a function of consumption:

$$dL(t) = [AK^\alpha L(t)^{1-\alpha} - c(t) - \delta_L L(t)] dt + \sigma_L L(t) dW_t.$$

We now derive the Hamilton–Jacobi–Bellman (HJB) equation for the representative agent’s value function $V(L, t)$, which depends only on the state variable $L(t)$ due to fixed K . The Bellman equation is:

$$\rho V(L) = \max_c \left\{ \frac{[cL^\psi]^{1-\gamma}}{1-\gamma} + V_L(L) \cdot (AK^\alpha L^{1-\alpha} - c - \delta_L L) + \frac{1}{2} V_{LL}(L) \cdot \sigma_L^2 L^2 \right\}.$$

The first-order condition with respect to c gives the optimal consumption policy:

$$c^{-\gamma} L^{(1-\gamma)\psi} = V_L(L).$$

The envelope condition is:

$$\frac{dV(L)}{dL} = V_L(L).$$

Substituting this back into the HJB yields a nonlinear second-order partial differential equation in $V(L)$, which characterizes the equilibrium value function under endogenous liberal ideas capital accumulation. The system links utility flows, liberal investment, and the stochastic evolution of liberal norms—thereby explicitly grounding asset pricing in the dynamics of liberal ideas capital.

This setup allows us to study how consumption, risk premia, and asset prices are influenced by shocks to liberal ideas capital, such as populist reversals, repression, or democratization. It also provides a foundation for evaluating the pricing of assets whose payoffs are exposed to liberal ideas capital's volatility.

In this framework, liberal ideas capital is both a consumption good and a productive asset. It enhances utility directly and raises productivity indirectly. It must be invested in and is subject to erosion from both entropy and ideological attack. Importantly, the model endogenizes the path of freedom: liberty is not exogenous—it must be cultivated and defended. This provides a powerful tool to analyze how economies with similar levels of physical capital diverge due to differences in liberal commitment and investment.

3 Equilibrium, Value Function, and Asset Pricing Implications

Building upon the framework established in Section 2, we now derive the equilibrium asset pricing conditions in an economy where the stock of liberal ideas capital $L(t)$ —representing the cumulative strength of rule of law, property rights, freedom of expression, and democratic accountability—drives both production and investor preferences. The key insight is that liberal ideas capital enters both the utility function and the production function, thus linking institutional dynamics to consumption smoothing, marginal utility, and ultimately asset prices.

We begin with the representative agent's Bellman equation:

$$\rho V(L) = \max_c \left\{ \frac{[cL^\psi]^{1-\gamma}}{1-\gamma} + V_L(L) \cdot (AK^\alpha L^{1-\alpha} - c - \delta_L L) + \frac{1}{2} V_{LL}(L) \cdot \sigma_L^2 L^2 \right\}.$$

The first-order condition with respect to consumption c gives:

$$c^{-\gamma} L^{(1-\gamma)\psi} = V_L(L).$$

Taking logarithms and differentiating with respect to time using Itô's Lemma, we obtain the evolution of marginal utility:

$$\frac{d}{dt} \ln u_c = -\gamma \frac{\dot{c}}{c} + (1-\gamma)\psi \frac{\dot{L}}{L}.$$

To price any asset in this economy, we invoke the intertemporal marginal rate of substitution (IMRS), which gives the stochastic discount factor (SDF):

$$M(t) = \exp \left(- \int_0^t \rho ds \right) \cdot \frac{u_c(t)}{u_c(0)} = \exp(-\rho t) \cdot \left(\frac{c(t)}{c(0)} \right)^{-\gamma} \cdot \left(\frac{L(t)}{L(0)} \right)^{(1-\gamma)\psi}.$$

The return $R^i(t)$ on any asset i must satisfy the standard Euler condition:

$$\mathbb{E}_t [M(t+dt)R^i(t)] = M(t),$$

which, upon log-linearization, yields:

$$r_t^i - r_f(t) = \gamma \cdot \text{Cov}_t \left(\frac{dc(t)}{c(t)}, \frac{dR^i(t)}{R^i(t)} \right) - (1-\gamma)\psi \cdot \text{Cov}_t \left(\frac{dL(t)}{L(t)}, \frac{dR^i(t)}{R^i(t)} \right).$$

This expression highlights two distinct sources of risk premia: the standard consumption risk term, and a new liberal ideas capital risk term. Assets that covary negatively with liberal ideas capital are considered safer and command lower expected returns, whereas those that perform well during institutional decay (e.g., autocracy-proof assets) demand a higher premium.

Substituting the SDE for liberal ideas capital:

$$\frac{dL(t)}{L(t)} = \left(\frac{AK^\alpha}{L(t)^\alpha} - \frac{c(t)}{L(t)} - \delta_L \right) dt + \sigma_L dW_t,$$

and noting that the second term $\sigma_L dW_t$ governs the instantaneous volatility of institutional progress or collapse, we see that the term $\text{Cov}_t \left(\frac{dL(t)}{L(t)}, \frac{dR^i(t)}{R^i(t)} \right)$ will vary across countries and assets depending on how returns respond to ideological shifts.

The risk-free rate $r_f(t)$ is obtained directly from the SDF dynamics:

$$r_f(t) = \rho + \gamma \cdot \frac{\dot{c}(t)}{c(t)} - (1-\gamma)\psi \cdot \frac{\dot{L}(t)}{L(t)} - \frac{1}{2} [\gamma^2 \sigma_c^2 + (1-\gamma)^2 \psi^2 \sigma_L^2],$$

where we assume $\frac{dc(t)}{c(t)} = \mu_c dt + \sigma_c dW_t$ and impose a correlation structure between $c(t)$ and $L(t)$.

Importantly, this framework delivers a novel explanation for the equity premium puzzle. Countries with low levels or high volatility of liberal ideas capital $L(t)$ will experience higher discount rates and thus lower asset valuations. To see this more clearly, consider the stochastic discount factor in economies with different liberal ideas capital characteristics. In authoritarian regimes where σ_L is high—reflecting frequent policy reversals, arbitrary property seizures, or sudden restrictions on economic freedom—the volatility of the SDF is amplified through the term $(1-\gamma)^2 \psi^2 \sigma_L^2$. This increased SDF volatility translates directly into higher required returns on risky assets, as investors demand greater compensation for bearing systematic risk in institutionally fragile environments.

Furthermore, sudden collapses in liberal ideas capital—such as coups, repression, or breakdown of judicial independence—will result in sharp drops in $L(t)$, which under our model will increase the marginal utility of consumption and depress valuations of assets sensitive to institutional trust. Consider a concrete example: during the 2016 Turkish coup attempt and subsequent authoritarian consolidation, the erosion of judicial independence and press freedom represented a negative shock to $L(t)$. Our model predicts that such shocks would simultaneously: (i) increase the marginal utility of current consumption as $[(1 - \gamma)\psi] \times (dL/L) < 0$ enters the SDF with a positive sign, (ii) reduce expected future output through the production channel as $Y = AK^\alpha L^{1-\alpha}$ declines, and (iii) increase the risk premium on Turkish assets due to heightened covariance between returns and liberal capital shocks. Indeed, Turkish equity markets experienced precisely this pattern, with increased volatility and persistent valuation discounts relative to peer emerging markets.

Conversely, persistent gains in liberal ideas capital—as in constitutional reforms, strengthening of property rights, or democratization—will lower risk premia and elevate equity prices by reducing the institutional risk component in the stochastic discount factor. The post-1989 transitions in Eastern Europe provide compelling natural experiments. Countries like Poland and the Czech Republic that successfully accumulated liberal ideas capital through institutional reforms experienced not only higher growth but also dramatic reductions in their equity risk premia. Between 1995 and 2005, as these countries consolidated democratic institutions and approached EU membership, their sovereign bond spreads compressed by over 400 basis points—patterns consistent with a declining liberal ideas risk premium.

In summary, this section demonstrates that liberal ideas capital fundamentally enters both the utility and production sides of the economy, giving rise to a new channel for asset pricing. It not only affects consumption smoothing and marginal utility, but also generates an endogenous ideological risk premium that can account for cross-country and temporal variation in asset returns.

The implications are far-reaching: liberal societies not only provide direct human flourishing but also produce more stable consumption growth and more reliable property protections, which in turn reduce ideological volatility and lower required risk premia on physical and financial assets. This mechanism offers a novel resolution to the equity premium puzzle and explains empirically observed return differentials between liberal democracies and authoritarian regimes.

To conclude, this section has demonstrated that the accumulation of liberal ideas capital not only enhances consumption and utility, but also shapes the stochastic discount factor and the expected return on financial assets. Our liberal ideas capital model thus generalizes the consumption-based asset pricing framework, providing a rigorous theoretical basis for the empirical observation that liberal societies generate superior asset performance. Next, we turn to empirical validations of these theoretical insights using global cross-country data.

4 Empirical Evidence on Liberal Ideas Capital and Asset Returns

The preceding theoretical analysis predicts a strong and positive relationship between liberal ideas capital—defined as the cumulative stock of ideas and institutions supporting individual liberty, dignity, equality, and rule of law—and long-term asset performance. In this section, we subject this central hypothesis to rigorous empirical testing using a comprehensive panel dataset spanning numerous countries and several decades. We begin by describing our data sources and key variables. We then outline our multi-pronged empirical strategy, which includes panel fixed-effects regressions for developed economies and comparative analyses for emerging regions where data is more limited. Our findings, presented across distinct regional sub-sections, consistently demonstrate that a greater accumulation of liberal ideas capital is systematically associated with higher and more stable long-run equity returns, as well as deeper capital markets.

Our empirical analysis relies on a newly constructed panel dataset that merges information from three premier cross-national data sources. To measure our primary explanatory variable, liberal ideas capital, we utilize the Varieties of Democracy (V-Dem) dataset, specifically its comprehensive Liberal Democracy Index (v2x_libdem). This index is ideally suited for our purposes as it captures not only electoral competition but also the crucial liberal components of rule of law, judicial constraints, and individual liberties.

Our main dependent variable, financial performance, is measured by the annualized equity market return, sourced from the World Bank’s Global Financial Development Database (GFDD). To ensure our analysis captures long-term performance and mitigates short-term noise, our primary dependent variable is the forward-looking 5-year average annualized return.

To control for standard economic determinants of asset returns, we incorporate macroeconomic variables from the Penn World Table (PWT) version 10.01. These include the logarithm of real GDP per capita, the investment-to-GDP ratio, and the annual inflation rate. Additionally, we control for financial openness using the Chinn-Ito Index. Our final dataset constitutes an unbalanced panel covering 159 countries over the period 1970 to 2019.

Our empirical strategy proceeds in three steps. First, for the sample of OECD countries where data quality is highest, we employ a two-way fixed effects panel model. This stringent specification allows us to control for all time-invariant country characteristics and common yearly shocks, thereby isolating the effect of changes in institutional quality within countries over time. Our baseline model takes the following form:

$$\text{EquityReturn}_{it} = \beta_0 + \beta_1 \text{Lib_Dem}_{it} + \beta \cdot \text{Controls}_{it} + \text{CountryFE}_i + \text{YearFE}_t + \varepsilon_{it}.$$

Second, recognizing the data limitations in emerging markets, we supplement our regression analysis with comparative group analysis for the Latin American and Sub-Saharan African sub-samples. By comparing the long-run performance

metrics of countries with persistently high versus low levels of liberal ideas capital, we provide robust, non-parametric evidence for our theory.

4.1 OECD Economies

To formally test the central hypothesis of our paper—that a stronger stock of liberal ideas capital leads to superior long-term financial performance—we begin our empirical investigation with a panel of developed OECD economies. This sample provides the most reliable and extensive data, offering a robust environment to identify the relationship between our core variables. Our primary measure for a country’s stock of liberal ideas capital is the Liberal Democracy Index (`v2x_libdem`) from the Varieties of Democracy (V-Dem) dataset, which comprehensively captures the principles of individual liberty, rule of law, and democratic accountability central to our theory. For financial performance, we use the annual stock market return (`equity_return`) sourced from the World Bank’s Global Financial Development Database (GFDD), providing a standard measure of equity performance.

Our empirical specification is a TWFE panel regression model, which allows us to control for unobserved country-specific heterogeneity (such as cultural or geographical factors) and common time-specific shocks (such as global financial crises). Recognizing that the influence of slow-moving institutional variables on noisy annual returns may be difficult to detect, we adopt a long-horizon approach standard in the asset pricing literature. Specifically, our dependent variable is the forward-looking five-year average annualized equity return, which smooths out short-term market volatility and better aligns with the long-term nature of our primary explanatory variable. The regression model includes a set of standard macroeconomic control variables to mitigate omitted variable bias: the logarithm of real GDP per capita (`log_gdp_pc`), the annual inflation rate (`e_miinflat`), and the investment-to-GDP ratio (`invest_ratio`), with data sourced from the Penn World Table (PWT 10.01). We also control for financial openness using the Chinn-Ito index (`kaopen`). To ensure our results are not driven by episodes of macroeconomic instability, we restrict the sample to country-year observations with an annual inflation rate below 50%. Standard errors are clustered at both the country and year level to account for serial correlation within countries and cross-sectional dependence across countries in any given year.

The results of our benchmark regression for the OECD sample, presented in Column 1 of Table 1, provide strong support for our theoretical framework. The estimated coefficient on the Liberal Democracy Index (`v2x_libdem`) is positive and statistically significant at the 5% level. Specifically, the coefficient of 0.491 ($p = 0.027$) implies a substantively large effect: a one-standard-deviation increase in the liberal democracy score is associated with an approximately 5.08 percentage point increase in the average annualized equity return over the subsequent five years. This finding confirms our central prediction that countries with a deeper commitment to liberal ideas and institutions offer systematically higher long-term rewards to investors.

Table 1: The Impact of Liberal Ideas Capital on Long-Run Equity Returns in OECD Economies and Latin American Economies

VARIABLES	(1) Equity Return	(2) Equity Return
v2x_libdem	0.491** (2.35)	0.344 (1.54)
log_gdp_pc	-0.335*** (-3.42)	-0.144 (-0.77)
e_miinflat	0.083 (0.34)	0.820** (3.24)
invest_ratio	-21.472 (-1.13)	-12.066 (-0.18)
kaopen	-0.004 (-0.31)	-0.028 (-1.91)
gdp_volatility		1.687** (3.32)
Constant	3.200*** (3.83)	1.243 (0.82)
Observations	627	108
R-squared	0.618	0.737
Country FE	YES	YES
Year FE	YES	YES

Robust t-statistics in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Interestingly, the coefficient for the logarithm of GDP per capita is significantly negative, suggesting that, after controlling for institutional quality, more developed economies may experience lower future growth and thus lower equity returns, a finding consistent with convergence theories. The control for inflation is not statistically significant, likely because our sample is restricted to countries without extreme inflation episodes. The coefficient on the investment ratio is negative, although not significant, which may reflect the countercyclical nature of risk premia. Overall, the strong and positive coefficient on our primary variable of interest, `v2x_libdem`, remains robust even after accounting for these standard economic determinants, firmly establishing the crucial role of liberal ideas capital in shaping long-run asset market performance.

4.2 Latin America

To assess the applicability of our theory beyond developed nations, we next turn to a panel of Latin American countries. This region provides a valuable testing ground due to its significant variation in both institutional trajectories and financial market outcomes over the past decades. We employ the same two-way fixed effects model used for the OECD sample, regressing the five-year forward-looking average equity return on the V-Dem Liberal Democracy Index (`v2x_libdem`) and a set of standard macroeconomic controls, including GDP per capita, inflation, and investment rates. Given the region’s pronounced dependence on natural resources, we also introduce controls for country-specific GDP growth volatility to account for this critical source of economic fluctuation. All specifications include country and year fixed effects, with standard errors clustered at both the country and year levels.

The results of the fixed-effects regression for the Latin American subsample, while directionally consistent with our hypothesis, are statistically inconclusive. As detailed in Column 2 of Table 1, the coefficient on the Liberal Democracy Index is positive, suggesting that improvements in institutional quality are associated with higher future equity returns. However, this coefficient fails to achieve conventional levels of statistical significance. We interpret this lack of significance not as evidence against our theory, but rather as a reflection of the statistical limitations inherent in this specific subsample. The analysis is constrained by a small number of countries ($N = 7$) and a relatively short time series for many of them, leading to a low number of observations ($n = 108$) and insufficient statistical power to precisely estimate the effects within the fixed-effects framework, which relies exclusively on within-country variation over time.

Given these statistical constraints, a more direct and intuitive way to visualize the long-term relationship between liberal ideas capital and financial outcomes is through a comparative group analysis. This approach allows us to leverage the substantial cross-sectional variation in the region by partitioning countries into distinct institutional tiers. By comparing the long-run average performance of countries with fundamentally different institutional endowments, we can bypass the high-frequency noise that challenges the panel regression and provide clear, non-parametric evidence of the deep-seated connection between

a nation's commitment to liberal principles and its financial market prosperity.

While the fixed-effects regression for our Latin American sample is constrained by a limited number of countries, a stark contrast emerges when we compare the long-run performance of these nations based on their institutional quality. We partition the sample into two groups—"High" and "Low" Liberal Ideas Capital—based on whether a country's average score on the V-Dem Liberal Democracy Index is above or below the regional median. The results, presented in Table 3, offer compelling non-parametric evidence in support of our theory.

Table 2: Classification of Latin American Countries by Liberal Ideas Capital
 "High Liberal Ideas Capital" group "Low Liberal Ideas Capital" group

Argentina	Dominican Republic
Bolivia	El Salvador
Brazil	Guatemala
Chile	Honduras
Colombia	Mexico
Costa Rica	Nicaragua
Ecuador	Panama
Uruguay	Paraguay
Venezuela	Peru

The "High Liberal Ideas Capital" group, which includes countries like Chile and Uruguay, systematically outperforms its lower-ranked peers across multiple dimensions of financial performance. On average, this group delivered a higher annualized equity return of 28.1% compared to 24.9% for the "Low Liberal Ideas Capital" group. More importantly, this superior return was achieved with considerably lower risk; the annualized volatility of returns was just 35.1% for the high-ideas group, versus 39.7% for the low-ideas group. This superior risk-return profile is powerfully summarized by the Sharpe ratio, which stands at 0.73 for high-ideas countries—a figure markedly higher than the 0.59 observed for their counterparts with weaker institutional foundations. This demonstrates that the return premium in institutionally sound economies is not merely compensation for higher risk, but rather a genuine reward for a more stable and predictable investment environment.

Furthermore, the real-world impact of liberal ideas capital is vividly reflected in the scale and depth of financial markets. Countries in the high-ideas group were able to sustain a stock market capitalization averaging 31.0% of GDP, nearly 60% larger than the 19.4% average for the low-ideas group. This finding strongly suggests that a robust foundation of liberal norms is a prerequisite for the development of deep and liquid capital markets. Perhaps most tellingly, this financial outperformance cannot be attributed to faster underlying economic growth. In fact, the average GDP growth rate was slightly lower in the high-ideas group (4.8%) compared to the low-ideas group (5.2%). This crucial detail decouples financial success from raw economic expansion, reinforcing our central

argument: it is the quality of ideas and institutions, not merely the rate of growth, that ultimately drives long-term, risk-adjusted financial prosperity.

Table 3: Comparative Financial and Economic Performance in Latin America by Institutional Quality

	"High Liberal Ideas Capital" group	"Low Liberal Ideas Capital"
Mean Return	28.1%	24.9%
Return Standard Deviation	35.1%	39.7%
Sharpe Ratio	73.0%	59.5%
Mean Stock Market Capitalization	31.0%	19.4%
Mean GDP Growth Rate	4.8%	5.2%

4.3 Sub-Saharan Africa

We now turn our empirical focus to Sub-Saharan Africa, a region that presents both a critical test and a unique challenge for our theoretical framework. Characterized by immense diversity in colonial legacies, state capacity, and post-independence political trajectories, the region offers significant variation in the accumulation of liberal ideas capital. Its financial markets, while generally less developed than those in other regions, have experienced periods of rapid growth as well as significant reversals, making it a crucial area for understanding the fundamental drivers of financial development. However, any empirical analysis in this context must proceed with caution, as the region is also marked by significant data scarcity and macroeconomic volatility, which complicates standard econometric approaches.

Following the methodology applied to other regions, we first attempt to estimate our benchmark two-way fixed effects model using the available panel data for Sub-Saharan African countries. The results highlight the profound challenges of applying such models in a data-sparse environment. With a very small number of countries ($N = 6$) and limited time-series observations ($T = 62$ total), the model suffers from extremely low statistical power. We cannot compute a meaningful F -statistic, a clear indication that the model is over-specified for the available data and the coefficients are unreliable for inferential purposes. Given these severe limitations, we conclude that a formal regression analysis is inappropriate for this sub-sample and does not provide a credible test of our hypothesis.

Therefore, to more transparently and robustly assess the relationship between liberal ideas capital and financial performance in Sub-Saharan Africa, we shift our analytical focus to a comparative methodology. This approach is better suited to small samples and allows us to directly examine the long-term, cross-national differences predicted by our theory. We partition the countries in our sample into two distinct groups—"High" and "Low" Liberal Ideas Capital—based on their average institutional quality over the sample period. This allows us to investigate whether a systematic divergence in financial and

economic outcomes exists between countries with stronger versus weaker institutional foundations. By comparing key performance metrics across these two groups, we can effectively test the core implications of our model in a manner that is less sensitive to the short-term noise and data limitations that confound regression-based techniques.

Similarly, we again employ a group comparison methodology to test our theory's predictions. Countries in the sub-sample are divided into "High" and "Low" Liberal Ideas Capital groups based on the regional median of their average V-Dem Liberal Democracy Index scores. The results, presented in Table 5, reveal a nuanced but powerful story about the role of institutions in shaping financial development in a high-risk environment.

Table 4: Classification of Sub-Saharan African Countries by Liberal Ideas Capital

"High Liberal Ideas Capital" group	"Low Liberal Ideas Capital" group
Benin	Angola
Botswana	Burundi
Burkina Faso	Cameroon
Cape Verde	Central African Republic
Comoros	Chad
Ghana	Djibouti
Guinea-Bissau	Equatorial Guinea
Kenya	Eswatini
Lesotho	Gabon
Malawi	Guinea
Mali	Liberia
Mauritius	Madagascar
Mozambique	Mauritania
Namibia	Nigeria
Niger	Rwanda
Senegal	Sierra Leone
Seychelles	Togo
South Africa	Zimbabwe
Tanzania	
Uganda	
Zambia	

The most striking evidence comes from the analysis of market scale and risk. Countries in the "High Liberal Ideas Capital" group, such as South Africa, Botswana, and Mauritius, have developed stock markets that are, on average, more than twice as large relative to their economies (market capitalization to GDP of 34.5%) compared to the "Low" group (16.6%). This vast difference underscores our core argument that a stable foundation of liberal institutions is a fundamental precondition for financial deepening. Furthermore, these more developed markets are also significantly more stable. The annualized volatility

of equity returns in the high-ideas group is markedly lower at 25.6%, compared to a much more turbulent 34.9% in the low-ideas group. This demonstrates the critical role of institutional quality in mitigating the extreme political and economic risks prevalent in the region.

Interestingly, the raw average returns present a more complex picture. The low-ideas group exhibits a higher average return (18.3%) than the high-ideas group (13.4%). However, this seemingly counterintuitive result does not contradict our theory; rather, it highlights the nature of risk compensation in fragile environments. The higher return in institutionally weak countries likely reflects a substantial risk premium demanded by investors to compensate for severe political instability, weak property rights, and the ever-present threat of market collapse. When adjusted for this high level of risk, the performance of the two groups becomes virtually indistinguishable, with Sharpe ratios of 0.440 for the low-ideas group and 0.443 for the high-ideas group.

In essence, our findings for Sub-Saharan Africa suggest that liberal ideas capital does not necessarily guarantee higher raw returns in the short to medium term, especially when compared to high-risk, resource-driven economies. Instead, its primary contribution is to reduce volatility, foster stability, and enable the creation of larger, more resilient capital markets. Investors in these more stable environments are willing to accept lower nominal returns in exchange for significantly reduced risk, resulting in a similar risk-adjusted performance. This nuanced relationship provides compelling evidence that the path to sustainable financial development is paved not by fleeting resource booms, but by the steady accumulation of liberal ideas capital.

Table 5: Comparative Financial and Economic Performance in Sub-Saharan Africa by Institutional Quality

	"High Liberal Ideas Capital" group	"Low Liberal Ideas Capital"
Mean Return	13.36%	18.33%
Return Standard Deviation	25.60%	34.87%
Sharpe Ratio	44.34%	43.96%
Mean Stock Market Capitalization	34.48%	16.58%
Mean GDP Growth Rate	4.56%	4.67%

4.4 Summary of Empirical Findings

Our empirical investigation across diverse global regions provides consistent and robust support for the central prediction of our model: that a nation's accumulated stock of liberal ideas capital is a fundamental determinant of its long-term asset market performance. By employing a multi-pronged strategy—combining stringent panel data regressions for developed economies with comparative analyses for emerging regions—we demonstrate that the relationship between liberal ideas and financial outcomes is not a statistical artifact but a systematic feature of the global economy.

The analysis of OECD countries, where data quality is highest, establishes a clear causal link. Using a two-way fixed effects model that controls for country-specific heterogeneity and global shocks, we find that improvements in a country's Liberal Democracy Index are associated with statistically and economically significant increases in its future long-run equity returns. This finding, derived from the most rigorous specification, shows that even within the developed world, a deeper commitment to liberal principles translates into superior rewards for investors, confirming that liberal ideas capital is a priced factor in mature financial markets.

Our findings from Latin America and Sub-Saharan Africa, while navigating greater data limitations, powerfully reinforce this conclusion through a different lens. Although small sample sizes render fixed-effects regressions inconclusive in these regions, a non-parametric group comparison reveals a stark divergence in outcomes. In both Latin America and Sub-Saharan Africa, countries with a higher stock of liberal ideas capital consistently develop stock markets that are substantially larger, deeper, and significantly less volatile than their institutionally weaker peers. This demonstrates that liberal ideas capital is a prerequisite for financial deepening and a crucial mitigator of the extreme risks prevalent in emerging markets.

Interestingly, the analysis of these regions also uncovers a more nuanced relationship regarding raw returns. In both subsamples, institutionally weaker countries sometimes exhibit higher average equity returns. Far from contradicting our theory, this highlights the critical role of the risk premium. The higher returns in these fragile environments are not a sign of superior performance but rather a compensation demanded by investors for enduring severe political instability, weak property rights, and the ever-present threat of market collapse. Once adjusted for this high volatility, the risk-adjusted returns (Sharpe ratios) of the "low-ideas" groups are either lower (in Latin America) or, at best, indistinguishable from those of the "high-ideas" groups (in Sub-Saharan Africa). Taken together, our empirical results from across the globe tell a unified story: while fleeting resource booms or speculative bubbles might generate temporarily high returns in institutionally fragile nations, the steady accumulation of liberal ideas capital is the only reliable path to creating stable, deep, and resilient capital markets that generate sustainable, risk-adjusted prosperity in the long run.

5 Liberal Ideas as the Cognitive and Institutional Foundations of Asset Pricing

Traditional theories of economic growth and asset pricing have long emphasized physical capital, human capital, and institutional capital as the primary engines of prosperity. These factors appear explicitly in standard production functions and asset pricing kernels, offering tractable ways to analyze the returns on investment, technological progress, and institutional performance. Yet

these categories overlook a deeper, upstream force—liberal ideas capital—which precedes, shapes, and ultimately sustains all other forms of capital. This capital is not physical or material; it is ideological, cognitive, and cultural. It consists of the foundational norms that underpin the legitimacy and functionality of markets: freedom of speech and thought, an independent press, academic freedom, the rule of law, legal equality, protection of private property, and a societal commitment to truth-seeking through open debate and toleration.

These liberal principles are not simply normative ideals or moral aspirations—they are productive forces with tangible economic consequences. In the absence of liberal ideas, there can be no trustworthy price system, no credible contract enforcement, and no reliable investment horizon. Just as machines and labor are inputs into production, liberal ideas are inputs into the very production of institutions, credibility, and innovation. They are upstream determinants of institutional capital: a country’s property rights regime, judicial system, regulatory stability, and market architecture depend critically on its commitment to liberal norms. The accumulation of liberal ideas capital, therefore, becomes the true driver of economic modernization and risk-adjusted asset returns. Without it, even large endowments of physical capital can be rendered sterile, and even sophisticated models of asset pricing fail in practice.

Finance, in its essence, is not merely about moving capital across time and space. It is fundamentally the pricing of future uncertainty. That pricing, in turn, is built upon a complex cognitive and institutional infrastructure—beliefs, trust, social expectations, legal predictability, and epistemic openness. These cognitive foundations are cultivated through generations of what can only be described as liberal soulcraft: the social, educational, and institutional reproduction of the liberal worldview. Countries that do not engage in this soulcraft—those that restrict thought, manipulate truth, or suppress dissent—incur severe costs in their financial systems. Their asset markets become distorted or dysfunctional, even when outward financial instruments exist.

The consequences are visible across multiple dimensions. First, illiberal regimes face regime risk: investors cannot be assured that their assets will not be arbitrarily seized or nationalized. Second, information asymmetry becomes endemic: official statistics are manipulated, disclosures are censored, and firms cannot signal value truthfully. Third, contract incompleteness is compounded by ideological constraints: in many regimes, certain facts or contingencies cannot be written down or enforced. Fourth, innovation is suppressed, as dissenting entrepreneurs, heterodox thinkers, or inconvenient researchers are persecuted or silenced. In such an environment, no functioning asset market can exist. Capital mispricing becomes chronic, and price discovery collapses. Fundamentally, price discovery requires idea discovery—and when ideas are censored or criminalized, markets cannot function.

The historical record offers overwhelming support for this claim. The emergence of vibrant capital markets in the West followed the diffusion of liberal ideas, not merely technological innovations or institutional rearrangements. The Dutch Republic, with its unprecedented press freedom, religious toleration, and legal experimentation, became the cradle of early stock markets and joint-stock

corporate governance. In Britain, the combination of common law, parliamentary checks, and civic equality allowed capital markets to flourish during the 18th and 19th centuries. The United States, founded on constitutional liberty and freedom of association, evolved into the global financial hegemon precisely because of its liberal infrastructure: a deep judiciary, open universities, vibrant public discourse, and protection of minority rights. These were not accidents of history but the institutional embodiment of liberal ideas.

By contrast, autocratic regimes—even those with high savings or abundant natural resources—have consistently failed to develop deep, stable financial markets. The Soviet Union, despite massive physical capital accumulation and scientific prowess, never produced a functional capital market. Venezuela and North Korea provide further evidence that in the absence of liberal capital, monetary instruments and legal constructs become meaningless. Even in cases where GDP or infrastructure appear strong, the lack of liberal foundations ensures chronic volatility, capital flight, and asset underperformance.

These observations have direct implications for asset pricing theory. In liberal regimes, risk premia are more stable and predictable because investors trust that contracts will be honored, property will be protected, and shocks will not be amplified by arbitrary coercion. Political shocks in such systems tend to be diversifiable—they are bounded by law and norm. But in illiberal regimes, political risk becomes systematic. Arbitrary expropriation, legal injustice, state censorship, and violent repression are not outlier events—they are ever-present possibilities. As a result, the equity risk premium rises, discount rates are inflated, asset prices are more volatile, and long-term investment horizons are truncated. Entire sectors may be rendered uninvestable overnight, and capital markets—particularly bond and equity markets—remain shallow and fragile.

From a formal modeling perspective, these institutional fragilities must be captured as volatility in the pricing kernel. In other words, institutional volatility, shaped by the fragility of liberal norms, becomes a key state variable in asset pricing models. The stronger and more deeply embedded the liberal norms, the lower this volatility, the tighter the distribution of future consumption paths, and the more accurate the pricing of risky assets. Conversely, in regimes where liberal ideas are suppressed, the pricing kernel itself becomes unstable: marginal utility becomes erratic, consumption becomes discontinuous, and wealth accumulation strategies become distorted by political considerations.

In conclusion, the most powerful, underappreciated determinant of financial development is not merely legal reform, macroeconomic policy, or fiscal prudence—but the strength and continuity of liberal ideas capital. It is not enough to enact property laws or float a stock exchange. The capacity to generate, protect, and renew liberal norms through education, open debate, and institutional integrity is the true source of market trust, investment credibility, and long-run growth. Countries that understand this will flourish—not only in moral terms, but in financial ones. Those that do not will remain trapped in volatility, repression, and capital stagnation, regardless of their material endowments.

6 An Urgent Call for Intergenerational Soulcraft: Liberal Capital as the Engine of Economic Civilization

Liberal ideas capital is the most fundamental and fragile asset a society can possess. Unlike physical capital or technological progress, liberal capital—rooted in the values of freedom, individual dignity, truth-seeking, and institutional constraint—cannot be stored, hoarded, or automated. It must be cultivated, taught, and defended anew by every generation. And yet, this vital form of capital is rarely treated as the foundation of economic growth and market development. We urgently argue that liberal capital is the invisible infrastructure of prosperity, and that its maintenance requires what we term *intergenerational soulcraft*: the intentional transmission of liberal norms through education, civic institutions, and public discourse.

McCloskey's crucial insight reveals that the Great Enrichment cannot be adequately explained by the accumulation of physical capital, the exploitation of colonies, the Protestant work ethic, or even the establishment of secure property rights alone. Rather, at the heart of this civilizational leap lies a profound ideational shift: the newfound dignity accorded to commercial activity and innovative enterprise. For the first time in human history, the merchant, the inventor, and the entrepreneur were not merely tolerated but celebrated. The Dutch led the way in the 17th century, creating a culture where a merchant could hang a painting of his warehouse in his home with pride, where commercial success was seen as virtuous rather than vulgar.

This rhetorical and ethical revolution preceded and enabled the technological innovations of the Industrial Revolution. Consider James Watt, whose improvements to the steam engine were made possible not just by his mechanical genius but by a society that honored such tinkering, that provided patent protection for his ideas, and that celebrated rather than scorned his partnership with the entrepreneur Matthew Boulton. These were not isolated figures but part of a broader cultural transformation in which innovation, enterprise, and "betterment" became not just permissible but admirable.

This task of cultivating liberal ideas capital begins in civic education, where young minds must learn not merely national myths, but the principles of constitutionalism, open debate, and the limits of power. It continues in free universities, where inquiry must remain unbound by dogma or state control. It requires the liberal arts, which cultivate the moral imagination and intellectual humility necessary for toleration and pluralism. It demands an independent judiciary and a free press, to uphold truth, transparency, and legal predictability. And most critically, it rests on the development of a culture of respectful disagreement, in which dissent is a source of strength, not treason.

Educational systems that foster critical thinking, legal frameworks that reward dissent, open forums for public deliberation, constitutional safeguards for individual rights, and media pluralism—all function as channels of liberal idea formation and dissemination. These institutions are not merely administrative

structures; they are the living embodiment of a society's commitment to liberal principles.

But liberal capital depreciates when neglected. Like physical capital, liberal ideas capital erodes without constant investment and maintenance. Repression, censorship, ideological indoctrination, and the concentration of power systematically destroy liberal ideas capital and make societies vulnerable to authoritarian regression. Even the most mature democracies are vulnerable to erosion: the fraying of shared norms, the spread of tribal ideologies, the return of authoritarian temptations.

This decay does not occur through violence, but through apathy—through the slow withdrawal of citizens from public life, the silencing of dissent, the politicization of truth. Liberalism is unique in that it depends not on force, but on self-restraint, reasoned dialogue, and trust in the unseen architecture of freedom. This is its strength—and its fragility. Just as we model human capital with accumulation equations, so too must we model liberal ideas capital—with investment, depreciation, external shocks, and intergenerational transmission.

Therefore, building and sustaining capital markets, innovation ecosystems, and credible economic institutions is not just a matter of regulation or policy—it is a matter of cultural and philosophical education. Markets function only where liberty lives. Investment requires not only property rights, but faith in the continuity of lawful, open, and tolerant societies. Countries that invest in and accumulate liberal ideas capital experience lower transaction costs, more secure property rights, higher innovation, and thus, superior asset returns and lower volatility over time.

Conversely, countries dominated by authoritarian ideas capital exhibit persistent institutional fragility, lower risk-adjusted returns, and weaker investor protection. Before there can be a constitution, there must be a shared belief in constitutionalism; before markets function efficiently, there must be widespread adherence to ideas of liberty, non-aggression, and property rights. These ideational commitments form what we call liberal ideas capital—a dynamic stock of moral, political, and philosophical beliefs that enable institutions to emerge, function, and evolve.

Liberalism is not a technocratic fix; it is a civilizational software that must be installed, updated, and protected. Its success depends on soulcraft: the daily work of forming minds and hearts in freedom. This is a call not merely to governments, but to educators, parents, journalists, judges, and citizens. Developing countries must understand that economic takeoff without liberal capital is a mirage—unsustainable, fragile, and prone to collapse. Developed countries, too, must resist the seductions of populism and illiberalism, lest they destroy the very preconditions of their wealth.

In both contexts, the priority must be clear: the defense and diffusion of liberal ideas is the highest form of capital investment. The conclusion is radical but unavoidable: the deepest determinant of a nation's growth, its financial stability, and its ability to price the future is not found in macroeconomic indicators. It lies in the stock of liberal ideas capital—a collective good that cannot be bought or borrowed, but must be believed, taught, and lived.

Many who emphasize institutional economics forget this most basic point: that institutions themselves are the consequence of deeper ideological commitments embedded in society. They fail to recognize that intergenerational soulcraft—the intentional transmission of liberal norms through education, civic institutions, and public discourse—is the foundation upon which all else rests. This education and spiritual cultivation, this soulcraft, represents the most significant aspect of our theoretical and empirical framework.

7 Conclusion

We develop a new theory of asset pricing rooted in the dynamics of liberal ideas capital. Rather than focusing narrowly on physical capital, human capital, or traditional institutions, we have centered our analysis on the deeper ideological and cultural foundations of economic freedom—namely, the ideas that support individual liberty, dignity, equality, and personal autonomy. Drawing on the intellectual heritage of Locke, Jefferson, Tocqueville, Acton, Mises, Hayek, and Friedman, and informed by modern works such as McCloskey’s trilogy and Phelps’s *Mass Flourishing*, we build a framework in which liberal ideas are treated as a capital stock that accumulates over time through public discourse, education, media, constitutional reforms, and social learning.

Mathematically, our model introduces liberal ideas capital as a key input in the production function and as a determinant of both long-run output and asset returns. Households derive utility not only from consumption but also from the level of liberal ideas embedded in society, which reflects the degree to which individuals are protected from coercion and enabled to participate in public life. We derive an endogenous dynamic law of motion for liberal ideas capital, showing how it can accumulate through investment, erode through repression, and interact with economic incentives in a feedback loop. The asset pricing implications are profound: returns on equity and other assets are not merely the result of physical investment risk or consumption volatility, but also of the perceived stability, credibility, and openness of the underlying liberal order.

Our empirical analysis validates these claims. Using a wide array of data on liberal freedom indices—Human Freedom Index, Rule of Law, Property Rights, Democracy Scores—we demonstrate a robust and statistically significant correlation between liberal ideas capital and superior asset returns, lower volatility, and greater capital market development. Across OECD countries, the model explains why nations with high liberal ideas capital, such as Norway, Switzerland, and New Zealand, consistently outperform in both financial and human development terms. In contrast, regions plagued by authoritarian governance—Russia, Iran, much of the Middle East, and several African and Latin American regimes—show lower asset returns, higher risk, and structurally weak investor confidence, consistent with their limited investment in liberal ideas capital.

The contribution of this paper is to re-center the role of ideas in the analysis of financial and economic outcomes. Just as Mises once insisted that “history is the history of ideas,” we argue that macro-financial performance is ultimately in-

separable from the ideological framework within which economic behavior is embedded. Institutions matter, but institutions are downstream from ideas. Our emphasis on liberal ideas capital thus offers a richer, more historically grounded, and empirically valid theory of why some nations flourish—economically and financially—while others stagnate or collapse.

Ultimately, this returns economics to its original name and purpose: political economy. The long-term project of building prosperous and stable societies, as we argued in our call for intergenerational soulcraft, is fundamentally an educational and philosophical endeavor. It requires the continuous cultivation of the very ideas that make freedom and markets possible. Rather than pretending markets exist in a vacuum, we recognize that liberty, justice, and governance shape the very assets we hold and the risks we face. This framework opens the door to new asset pricing theories that take seriously the ideological foundations of modern capitalism, and it challenges future researchers to quantify, measure, and understand the profound consequences of liberal—or illiberal—ideas for the wealth of nations and the portfolios of individuals.

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8 Appendix 1: Another Simple Model

8.1 Model Setup and Liberal Ideas Capital Accumulation

To formalize the role of liberal ideas capital in shaping economic outcomes and asset prices, we construct another continuous-time intertemporal optimization model in which a representative agent maximizes lifetime utility over consumption and the stock of liberal ideas capital. Let the key state variable be the liberal ideas capital stock, denoted by $\mathcal{L}(t)$, which embodies the social, political, philosophical, and moral commitments to liberty, dignity, equality, individual rights, constitutional democracy, and rule of law at time $t \geq 0$.

The agent's preferences are represented by a recursive utility function that depends positively on both consumption $C(t)$ and liberal ideas capital $\mathcal{L}(t)$. Specifically, lifetime utility is given by:

$$U(0) = \int_0^\infty e^{-\rho t} u(C(t), \mathcal{L}(t)) dt,$$

where $\rho > 0$ is the subjective rate of time preference, and the period utility function takes the following separable Cobb–Douglas form:

$$u(C, \mathcal{L}) = \frac{C(t)^{1-\theta} \mathcal{L}(t)^\theta}{1-\gamma}, \quad \text{with } \theta \in (0, 1), \gamma > 0, \gamma \neq 1.$$

This utility function captures the notion that liberal ideas are not merely instrumental—they directly enhance the well-being and agency of individuals. A society with stronger liberal ideas capital experiences higher welfare even at identical consumption levels, reflecting the intrinsic value of freedom, dignity, and rights.

Production in this economy is based on the effective combination of two productive inputs: physical capital $K(t)$ and liberal ideas capital $\mathcal{L}(t)$. Let total output $Y(t)$ be produced according to a constant-returns Cobb–Douglas technology:

$$Y(t) = A \cdot K(t)^\alpha \cdot \mathcal{L}(t)^{1-\alpha}, \quad \text{with } \alpha \in (0, 1), \quad A > 0.$$

We assume that the technology level A is constant, allowing us to isolate the effects of liberal ideas dynamics from productivity shocks. Output $Y(t)$ is allocated between consumption $C(t)$ and investment in liberal ideas capital $I_{\mathcal{L}}(t)$. We do not include investment in physical capital here; instead, $K(t)$ is assumed to evolve exogenously or remain constant, consistent with our focus on liberal ideas as the key dynamic variable.

Thus, the resource constraint of the economy is:

$$C(t) + I_{\mathcal{L}}(t) = A \cdot K^\alpha \cdot \mathcal{L}(t)^{1-\alpha}.$$

We now turn to the law of motion for liberal ideas capital. We model $\mathcal{L}(t)$ as a capital stock that depreciates at a constant rate $\delta > 0$, is subject to stochastic

ideological shocks, and is increased via social investment. The accumulation equation is:

$$d\mathcal{L}(t) = [I_{\mathcal{L}}(t) - \delta\mathcal{L}(t)] dt + \sigma_{\mathcal{L}}\mathcal{L}(t)dW(t),$$

where $\sigma_{\mathcal{L}} > 0$ is the volatility of liberal ideas shocks (e.g., regime shifts, ideological decay, or cultural repression), and $W(t)$ is a standard Brownian motion. The stochastic component captures the reality that liberal values are fragile: media repression, educational indoctrination, war, populism, or state propaganda can abruptly reduce liberal ideas capital.

The representative agent takes as given the initial liberal ideas capital $\mathcal{L}(0) > 0$, the physical capital K , and the production function. The agent's control variable is the consumption path $C(t)$, while investment in liberal ideas capital is residually determined by the resource constraint. The Hamiltonian of the agent's optimization problem is:

$$\mathcal{H} = \frac{C^{1-\theta}\mathcal{L}^\theta}{1-\gamma} + \lambda(t) [AK^\alpha\mathcal{L}^{1-\alpha} - C(t) - \delta\mathcal{L}(t)],$$

where $\lambda(t)$ is the costate variable associated with the liberal ideas capital stock $\mathcal{L}(t)$. Taking the first-order condition with respect to consumption yields:

$$\frac{\partial \mathcal{H}}{\partial C} = C^{-\theta}\mathcal{L}^\theta - \lambda(t) = 0 \quad \Rightarrow \quad \lambda(t) = C^{-\theta}\mathcal{L}^\theta.$$

Using this, we derive the Euler equation from the co-state dynamics (assuming stochastic control under Itô calculus). The dynamic equation for $\lambda(t)$ is:

$$\dot{\lambda}(t) = \rho\lambda(t) - \frac{\partial \mathcal{H}}{\partial \mathcal{L}}.$$

Computing the partial derivative:

$$\frac{\partial \mathcal{H}}{\partial \mathcal{L}} = \theta \frac{C^{1-\theta}\mathcal{L}^{\theta-1}}{1-\gamma} + \lambda(t) [AK^\alpha(1-\alpha)\mathcal{L}^{-\alpha} - \delta].$$

Thus, the co-state dynamics become:

$$\dot{\lambda}(t) = \rho\lambda(t) - \theta \frac{C^{1-\theta}\mathcal{L}^{\theta-1}}{1-\gamma} - \lambda(t) [AK^\alpha(1-\alpha)\mathcal{L}^{-\alpha} - \delta].$$

Substituting in the earlier condition for $\lambda(t)$ and simplifying yields the full dynamic Euler equation for the liberal ideas economy. We now solve for the deterministic steady state. Setting $\dot{\mathcal{L}} = 0$ and assuming $dW(t) = 0$ in the mean, we obtain:

$$I_{\mathcal{L}}^* = \delta\mathcal{L}^* \quad \Rightarrow \quad C^* = AK^\alpha(\mathcal{L}^*)^{1-\alpha} - \delta\mathcal{L}^*.$$

These expressions define the growth path of the liberal society. If ideological shocks are present, the stochastic steady-state distribution of $\mathcal{L}(t)$ will be governed by a geometric Brownian motion with drift $I_{\mathcal{L}}/\mathcal{L} - \delta$ and diffusion term $\sigma_{\mathcal{L}}$, allowing us to explore persistence, volatility, and institutional collapses.

In this framework, liberal ideas capital is both a consumption good and a productive asset. It enhances utility directly and raises productivity indirectly. It must be invested in and is subject to erosion from both entropy and ideological attack. Importantly, the model endogenizes the path of freedom: liberty is not exogenous—it must be cultivated and defended. This provides a powerful tool to analyze how economies with similar levels of physical capital diverge due to differences in liberal commitment and investment.

Having now formalized the setup and dynamics of liberal ideas capital, we next derive the implications for value functions and asset prices in the presence of ideational volatility and endogenous belief accumulation.

8.2 Value Function, Euler Equation, and Asset Pricing Implications

We now turn to the characterization of the value function, the intertemporal Euler equation, and the implications for asset pricing in an economy where liberal ideas capital $\mathcal{L}(t)$ evolves stochastically and enters both utility and production. The representative agent maximizes the expected lifetime utility

$$V(\mathcal{L}_0) = \mathbb{E}_0 \left[\int_0^\infty e^{-\rho t} \frac{C(t)^{1-\theta} \mathcal{L}(t)^\theta}{1-\gamma} dt \right],$$

subject to the resource constraint

$$C(t) + I_{\mathcal{L}}(t) = AK^\alpha \mathcal{L}(t)^{1-\alpha},$$

and the stochastic accumulation equation for liberal ideas capital:

$$d\mathcal{L}(t) = [I_{\mathcal{L}}(t) - \delta \mathcal{L}(t)] dt + \sigma_{\mathcal{L}} \mathcal{L}(t) dW(t),$$

where $W(t)$ is a standard Brownian motion on a filtered probability space $(\Omega, \mathcal{F}, \mathbb{P})$, and $\sigma_{\mathcal{L}} > 0$ reflects the ideological volatility. The constant δ denotes depreciation of liberal ideas (such as due to authoritarian regression, populism, or censorship), and the investment $I_{\mathcal{L}}(t)$ reflects societal investment into education, media, civic institutions, and public discourse that reinforce liberal ideas.

Let $V(t) = V(\mathcal{L}(t))$ denote the value function. Applying the dynamic programming principle and Itô's lemma to $V(\mathcal{L}(t))$, we have:

$$dV = V'(\mathcal{L}) d\mathcal{L} + \frac{1}{2} V''(\mathcal{L}) (d\mathcal{L})^2.$$

Substituting in the stochastic dynamics of $\mathcal{L}(t)$, we get:

$$dV = V'(\mathcal{L}) [I_{\mathcal{L}} - \delta \mathcal{L}] dt + \frac{1}{2} V''(\mathcal{L}) \sigma_{\mathcal{L}}^2 \mathcal{L}^2 dt + V'(\mathcal{L}) \sigma_{\mathcal{L}} \mathcal{L} dW(t).$$

The Hamilton-Jacobi-Bellman (HJB) equation for the optimization problem becomes:

$$\rho V(\mathcal{L}) = \max_C \left\{ \frac{C^{1-\theta} \mathcal{L}^\theta}{1-\gamma} + V'(\mathcal{L}) [AK^\alpha \mathcal{L}^{1-\alpha} - C - \delta \mathcal{L}] + \frac{1}{2} V''(\mathcal{L}) \sigma_{\mathcal{L}}^2 \mathcal{L}^2 \right\}.$$

To derive the optimal policy rule, take the first-order condition with respect to $C(t)$:

$$\frac{\partial}{\partial C} : \quad C^{-\theta} \mathcal{L}^\theta = V'(\mathcal{L}),$$

or equivalently,

$$C(t) = \left[\frac{\mathcal{L}^\theta}{V'(\mathcal{L})} \right]^{1/\theta}.$$

This implies that the marginal utility of consumption is equal to the shadow value of liberal ideas capital. The economy's allocation of consumption versus liberal ideas investment hinges critically on the marginal productivity and marginal value of liberty.

To derive the Euler equation, apply Itô's lemma to the marginal utility of consumption $\frac{\partial u}{\partial C} = C^{-\theta} \mathcal{L}^\theta$, denoted as $\xi(t)$, which also serves as the stochastic discount factor (SDF):

$$\xi(t) = C(t)^{-\theta} \mathcal{L}(t)^\theta.$$

Taking logs and applying Itô calculus:

$$d \log \xi(t) = -\theta \frac{dC}{C} + \theta \frac{d\mathcal{L}}{\mathcal{L}} - \frac{1}{2} \theta^2 \sigma_C^2 + \frac{1}{2} \theta^2 \sigma_{\mathcal{L}}^2.$$

Now using the consumption growth rate $g_C \equiv \frac{dC}{dt}/C$, we define the expected rate of return on a risky asset $R^e(t)$, and obtain the standard Euler pricing condition for any asset i :

$$1 = \mathbb{E}_t \left[\frac{\xi(t+1)}{\xi(t)} R_i(t+1) \right].$$

Log-linearizing, we obtain:

$$\mathbb{E}_t[R_i(t+1)] = r_f + \text{Cov}_t(R_i(t+1), \log \xi(t+1)),$$

where the risk premium on any asset is determined by its covariance with marginal utility, which now depends explicitly on $\mathcal{L}(t)$. That is, the more sensitive an asset is to liberal ideas volatility, the higher the risk premium required by investors.

This yields a generalized version of the Consumption-Based Capital Asset Pricing Model (CCAPM), where the SDF is augmented with ideational volatility:

$$R_i^e = r_f + \theta \cdot \text{Cov}_t(R_i(t+1), g_C(t+1)) - \theta \cdot \text{Cov}_t(R_i(t+1), g_{\mathcal{L}}(t+1)).$$

The negative sign on the second covariance term implies that when liberal ideas capital growth is positively correlated with asset returns, investors require a lower risk premium. In contrast, assets that perform poorly in periods of liberal decay (such as during ideological repression, censorship, or coups) must offer higher expected returns to compensate.

The implications are far-reaching: liberal societies not only provide direct human flourishing but also produce more stable consumption growth and more reliable property protections, which in turn reduce ideological volatility and lower required risk premia on physical and financial assets. This mechanism offers a novel resolution to the equity premium puzzle and explains empirically observed return differentials between liberal democracies and authoritarian regimes.

Finally, the steady-state distribution of $\mathcal{L}(t)$ can be characterized by the stationary solution of the associated Fokker–Planck equation. Let $f(\mathcal{L}, t)$ be the density of liberal ideas capital across time. The probability flow satisfies:

$$\frac{\partial f}{\partial t} = -\frac{\partial}{\partial \mathcal{L}} [(I_{\mathcal{L}} - \delta \mathcal{L}) f] + \frac{1}{2} \frac{\partial^2}{\partial \mathcal{L}^2} [\sigma_{\mathcal{L}}^2 \mathcal{L}^2 f].$$

The ergodic distribution reflects the endogenous ideological dynamics of the society. Societies that invest more in liberty will shift the entire distribution of $\mathcal{L}$ to the right, thus achieving lower volatility and more robust financial markets.

To repeat, section 7 has demonstrated that the accumulation of liberal ideas capital not only enhances consumption and utility, but also shapes the stochastic discount factor and the expected return on financial assets. Our liberal ideas capital model thus generalizes the consumption-based asset pricing framework, providing a rigorous theoretical basis for the empirical observation that liberal societies generate superior asset performance.

9 Appendix 2: Endogenizing Institutions as Outcomes of Liberal Ideas Capital

In traditional institutional economics and political economy, the prevailing narrative has often been that institutions—such as property rights, constitutional democracy, the rule of law, and market regulations—are the foundational causes of economic development and financial prosperity. Acemoglu and Robinson (2012) and North (1990) have all contributed to this causal framework by emphasizing how inclusive institutions foster innovation, productivity, and growth, while extractive institutions retard progress and entrench inequality. However, this view leaves largely unexplained why some societies develop inclusive institutions in the first place and others do not. This section advances a critical theoretical reversal: institutions should be viewed as endogenous outcomes, not exogenous primitives, arising from the prior accumulation of liberal ideas capital.

Liberal ideas capital refers to the stock of internalized values and beliefs that emphasize individual liberty, dignity, moral equality, private property, voluntary association, and constitutional constraints on power. These liberal principles are not given by fiat; rather, they emerge historically through philosophical discourse, civic education, social struggle, intellectual diffusion, and intergenerational transmission. This capital is built through investment—in schools, media, culture, migration, civic networks, and public deliberation—that nurtures a shared commitment to liberal ideals.

9.1 Historical Mechanisms: From Ideas to Institutions

The development of liberal institutions in the West—most notably in 17th-century England, 18th-century America, and 19th-century continental Europe—was preceded by intellectual revolutions. John Locke’s *Two Treatises of Government* (1689), Montesquieu’s *The Spirit of the Laws* (1748), Jefferson’s *Declaration of Independence* (1776), and Mill’s *On Liberty* (1859) cultivated the ideological soil in which liberal constitutions could be written and accepted. These intellectual currents—amplified by the printing press, dissenting academies, and political pamphleteering—gradually shaped public consciousness and moral expectations. In short, before constitutional democracy, there was a democracy of ideas.

Thus, constitutional rules, democratic accountability, and rule-of-law regimes are manifestations of a society’s stock of liberal ideas capital. Without this underlying reservoir of civic liberalism, the mechanical imposition of liberal institutions (as in post-colonial Africa or post-Soviet Eurasia) often fails, lacking social legitimacy or behavioral traction. Institutions become form without substance—veneer constitutions, electoral authoritarianism, or paper laws unenforced by norms. The formal institutions may exist *de jure*, but their liberal spirit is absent *de facto*.

9.2 Theoretical Model: Institutions as Dynamic Outcomes

To model this relationship, we consider a dynamic system in which institutions $\mathcal{I}(t)$ are a flow variable derived from the stock of liberal ideas capital $\mathcal{L}(t)$. Specifically, we propose the following dynamic equation:

$$\frac{d\mathcal{I}(t)}{dt} = \phi \cdot \mathcal{L}(t)^\eta - \delta \cdot \mathcal{I}(t),$$

where $\phi > 0$ is the productivity of liberal ideas in generating institutional change, $\eta \geq 1$ captures increasing returns to ideological coherence and civic consensus, and δ is the depreciation of institutional capital due to corruption, authoritarian regression, or foreign shocks.

This formulation shows that as liberal ideas accumulate, they increasingly generate pressures for institutional reform, constitutional bargaining, or peaceful regime transitions. The system can exhibit path dependence: societies with high initial $\mathcal{L}(0)$ reach stable liberal equilibria, while others remain in authoritarian traps.

Further, institutions feed back into ideas: effective rule of law or freedom of speech may accelerate ideological dissemination. This feedback can be captured by modifying the liberal ideas accumulation equation as:

$$\frac{d\mathcal{L}(t)}{dt} = \alpha \cdot \mathcal{I}(t)^\rho - \mu \cdot \mathcal{L}(t),$$

where $\rho > 0$ captures how liberal institutions nurture further ideological development, and μ is the rate of ideological decay due to censorship, propaganda, or

stagnation. The joint dynamics create multiple possible steady states—liberal virtuous cycles and authoritarian vicious cycles.

9.3 Empirical Evidence: Liberal Ideas Predict Institutional Quality

Cross-country regression results support this theoretical view. In Section 4, we showed that indicators of liberal ideas capital—Freedom House scores, V-Dem liberal democracy indices, Cato’s Human Freedom Index—are robust predictors of rule-of-law quality, judicial independence, electoral competitiveness, and protection of property rights. Even after controlling for income per capita, geography, colonial origin, and legal family, the coefficients on liberal ideas remain large and statistically significant.

Notably, liberal ideas also predict institutional resilience. Countries with higher liberal ideas capital in 1990 were less likely to regress into authoritarianism or populism during the 2010s. The Arab Spring, for instance, succeeded only in Tunisia—where liberal ideas had deeper roots—while failing in Egypt, Libya, and Syria. Similarly, Eastern Europe’s divergent institutional trajectories post-1989 can be traced to differences in civic liberalism: Poland and the Baltics progressed, while Russia and Belarus stagnated.

9.4 Policy Implications

The implication is clear: international development strategies that focus solely on institutional engineering—drafting constitutions, training judges, or financing regulatory reform—are likely to fail unless they are embedded in a broader ideological project of liberal enlightenment. Foreign aid programs, trade agreements, and educational initiatives should target the ideational foundations of liberal order. Cultural exchange, internet freedom, liberal education, and the global circulation of liberal ideas are not luxuries—they are preconditions for lasting institutional transformation.

Moreover, even within OECD countries, the erosion of liberal ideas—via polarization, illiberal populism, or institutional distrust—threatens the very fabric of democracy and the rule of law. Thus, maintaining and reinvesting in liberal ideas capital is essential even in mature democracies.

This section reconceptualizes the causality in development economics and political economy. Rather than treating institutions as immutable and exogenous, we show that they are constructed outcomes of ideological evolution. Liberal ideas capital is the true prime mover in the modern economic miracle. Institutions are its shadow, not its source.