European Journal of Political Economy 45 (2016) 11–23

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

Economic freedom and economic crises

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A R T I C L E   I N F O

Article history:
Received 7 June 2015
Received in revised form 2 August 2016
Accepted 2 August 2016
Available online 4 August 2016

JEL classification:
O11
O43
P16

Keywords:
Crisis
Economic freedom
Institutions

A B S T R A C T

In this paper, I explore the politically contested association between the degree of capitalism, captured by measures of economic freedom, and the risk and characteristics of economic crises. After offering some brief theoretical considerations, I estimate the effects of economic freedom on crisis risk in the post-Cold War period 1993–2010. I further estimate the effects on the duration, peak-to-trough GDP ratios and recovery times of 212 crises across 175 countries within this period. Estimates suggest that economic freedom is robustly associated with smaller peak-to-trough ratios and shorter recovery time. These effects are driven by regulatory components of the economic freedom index.

1. Introduction

In the aftermath of events such as the collapse of the Asian crisis in 1997–1998, the collapse of the dot-com bubble in 2000–2001, and the financial crisis of 2008 and the subsequent Great Recession, the media and popular political literature have filled with claims about whom and what is to blame for economic crises and instability. Some commentators, including economists, sociologists and political scientists, claim that unrestrained capitalism creates economic crises and markets need to be regulated and subjected to political control. This predominantly left-wing claim originally derives from the first volume of *Das Kapital*, in which Karl Marx predicted that capitalism would produce steadily deeper crises that would lead to its demise. Recent thinking on the political left wing continues to reflect this claim, as Chomsky (2009) for example argues that deregulation since the 1970s has produced more frequent crises and increasing economic inequality. Klein (2007) even goes as far as claiming that governments actively engineer economic crises in order to convince voters to accept liberalizing reforms.

While these commentators all praise political freedom in the guise of democracy, their argument is that substantial economic freedom is related to more frequent and deeper crises. Krugman (2008, 189) for example argues that the most recent crisis was created by deregulation of the financial sector and that many future crises can only be prevented through regulation because "anything that … plays an essential role in the financial mechanism should be regulated when there isn't a crisis so that it doesn't take excessive risks." Stiglitz (2009) makes a very similar point in arguing that deregulation and liberalization triggers financial and economic crises by creating excessive risk-taking behaviour and outright fraud. Both take their starting point in Keynes, who in the economic turmoil following World War I in 1923 expressed the belief that "The more troublous the times, the worse does a laissez-faire system work" (cited in Grant, 2014, 205).

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http://dx.doi.org/10.1016/j.ejpoleco.2016.08.003
0176-2680/

Classical liberal and conservative right-wing commentators and social scientists conversely argue that most financial and economic crises are created and prolonged by government regulations, poor institutions and activist policy failures. Most famously, Friedman and Schwartz (1963) documented how the Great Depression of 1929 and the subsequent crisis were partially created and prolonged by repeated monetary policy failures. Higgs (1997) additionally argued that the Great Depression was deepened and prolonged by Hoover's interventions and Roosevelt's New Deal policies, both of which included tight and direct market regulations and control of individual firms. Baker et al. (2012) document similar effects of policy uncertainty deriving from erratic, discretionary policy interventions during the recent crisis in the US while Zingales (2012) employs the concept of crony capitalism to diagnose the causes of both recent and historical world-wide crises. Although he does not use the specific term, Krugman's (1999) explanation for the Asian crisis of 1997–98 also rests on crony capitalism: as public bail-out guarantees fuelled an unsustainable credit expansion and thereby an economic bubble that resulted in a severe crisis, the Asian crisis was in large part created by policy failures.

Current discussions about the appropriate policy responses and institutions that either prevent crises or alleviate crisis loses are therefore often situated in a larger, ongoing discussion of the relative advantages and deficiencies of capitalist institutions. While one strand of the popular literature argues that capitalism is either directly destructive or needs to be reined in and regulated by democratic political institutions (Klein, 2007; Krugman, 2008; Stiglitz, 2009), another strand is either highly sceptical towards the ability of political institutions or emphasizes the self-regulating aspects of unregulated markets (e.g. Grant, 2014; Norberg, 2003; Pennington, 2011). The claims made in these strands of the literature are therefore exactly opposite with one side arguing that economic freedom is harmful to human well-being by creating frequent economic disruptions and the other arguing that substantial economic freedom protects societies from such damaging disruptions. The international debate is fierce and politically influential in several countries, yet remains oddly uninformed because very little is actually known about the relation between economic freedom and crisis risk and characteristics.

The two main questions addressed in this paper therefore are: 1) are more capitalist economies – societies that are economically relatively free – more or less prone to experience economic crises; and 2) do crises hitting such economies have more or less economically damaging consequences? I answer these questions by estimating the effects of economic freedom, measured by the annual Index of Economic Freedom (IEF) from the Heritage Foundation, on subsequent crisis risk, and on the duration, depth and recovery time of crises, when they occur. The full dataset includes 212 economic crises across 175 countries, of which 121 experienced at least one crisis or longer recession during the post-Cold War period between 1993 and 2010.

The results suggest that increased economic freedom is only weakly associated with the probability of observing a crisis, and not at all with the duration of the economic downturn of the crises. However, countries that are more economically free when entering a crisis are clearly likely to experience substantially smaller crises, measured by the peak-to-trough GDP ratio, and have shorter recoveries to pre-crisis real GDP. These differences are driven by elements of the IEF related to regulatory activity while government spending, rule of law and market openness in general are not robustly related to crisis characteristics.

The rest of the paper is organized as follows. Section 2 outlines some simple theoretical considerations of how economic freedom might affect economic crisis. Section 3 describes the data used in Section 4, which reports estimates of crisis risk, and Section 5 that reports estimates of crisis characteristics. Section 6 concludes.

2. Basic considerations and literature

Policies and institutions can, in principle, be associated with crises in three ways. First, they can affect the volatility of domestic economic development and the way international business cycles are propagated to the economy, i.e. the sensitivity of domestic demand to international shocks. Second, economic policies can affect the aggregate demand reaction to crises, such as is the traditional role of Keynesian stabilization policy. Third, economic policies and institutions can affect the supply response to crisis, and in particular the flexibility of the economy when resources are to be reallocated from uses made either redundant or unprofitable by the crisis shock.

2.1. Arguments against economic freedom

In the context of crisis risk, Baier et al. (2012) note that a perfectly communist society with no economic freedom does not suffer economic crises due to international shocks or domestic demand collapses. However, such societies also failed to develop at a pace comparable to non-communist societies, and many communist societies were in reality in continual crisis from some time in the 1960s. To many economists since Lange (1936) and Lerner (1938) in the 1930s, the question has therefore been to identify what would be 'good' regulations and proper centralized planning, not least those elements stabilizing the economy and alleviating crises once they occur. Keynesian economics, arising out of such discussions, provided a middle-way between the outright socialist view and classical and neo-classical economics.

First, traditional Keynesian logic holds that the main problem during crises is the demand loss incurred on private agents. Societies with higher taxes, larger government spending and more generous welfare states ought, all other things being equal, to be characterized by relatively small fiscal multipliers. Generous unemployment insurance and other transfers to unemployed or people entirely leaving the labour market also provide automatic stabilizers that would tend to limit the demand loss during the beginning of a crisis. In all cases, these characteristics would mean that an exogenous economic shock would have smaller demand consequences in large welfare states, i.e. societies characterized by less economic freedom in the form of large government and