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Killing the Economic Engine: Is Policy Uncertainty Stalling US and Canadian Economic Growth?

by Professor Nicholas Bloom

Main Conclusions

- **Increases in policy uncertainty forecast future drops in economic growth and employment.**
- **Following an increase in policy uncertainty of the size seen on average between 2006 and 2011, industrial production in the US dropped by 2.5 percent and employment by 2.4 million.**
- **Much of Canada's current economic policy uncertainty is due to contagion from the US.**
- **The US and Canadian economies would benefit demonstrably if economic uncertainty emanating from policy were reduced. Unfortunately, this looks unlikely to occur soon. Economic policy uncertainty is the new normal.**

Introduction

Policy conflict and fiscal crisis in the United States and Europe have spurred concerns about policy uncertainty and its economic effects. Many policymakers, businesspeople, and the media suggest that the political crisis in Washington is leading firms and consumers to postpone hiring and spending decisions, stalling the recovery from the 2007-2009 recession. This essay seeks to investigate this assertion by answering three questions. First, is economic policy uncertainty high in the US and Canada? Second, if so, is this damaging the economy? Finally, what are the prospects for future policy stability and economic growth? In addressing these questions I will draw heavily on the academic paper by Baker, Bloom, and Davis (2013) as well as the data provided online at www.policyuncertainty.com.

Is economic policy uncertainty high in the US and Canada?

Measuring economic policy uncertainty is not easy; uncertainty is a subjective concept. But we can generate a proxy for policy uncertainty using three groups of observable measures and combining them into one measure of Economic Policy Uncertainty (EPU). This combined measure of policy uncertainty in the US is calculated as an index and is plotted in figure 1. It shows policy uncertainty in the US varying over time, rising after major wars (such as the first and second Gulf Wars), elections, and terrorist attacks. However, and critically important for the purposes of this essay, the index shows that policy uncertainty surged upwards in 2008 and has remained high.

In short, policy uncertainty appears to have remained stubbornly high since 2008. Before analyzing its potential impact, it is worth briefly summarizing the three sub-components included in our Economic Policy Uncertainty measurement. The first component quantifies newspaper coverage of policy-related economic uncertainty. This uses computer searches of 10 major US newspapers (such as the New York Times, the Wall Street Journal, USA Today, etc.) for articles that mention “uncertain”¹, “econom” and one of 6 policy words or word groups: “congress,” “deficit,” “federal reserve,” “legislation,” “regulation,” and “White House.” This is normalized by the count of all articles in each paper each month, then normalized to have a standard

deviation of 1 in each paper, and then added up across all 10 papers.

The second component reflects the number and size of federal tax code provisions set to expire in future years. It uses the Congressional Budget Office’s list of the dollar value of expiring tax code provisions, and a 50% annual discount rate (thereby focusing on near-term expirations) to generate a tax expiration index.

The third component captures disagreement among economic forecasters in the Philadelphia Federal Reserve’s Survey of Professional Forecasters. This component combines the interquartile range of 1-year-ahead quarterly forecasts of federal, state and local government purchases (normalized by a backward looking moving average of GDP) and the interquartile range of Consumer Price Index forecasts.

To create our overall measure of policy uncertainty, we place a $\frac{1}{2}$ weight on the news index, and $\frac{1}{6}$ each on the tax-expiration, government purchases disagreement, and CPI disagreement indices. Next, each measure is normalized to have a standard deviation of 1. The index is then finally normalized to have a value of 100 prior to 2011, and this is shown in figure 1.

Using this data we can also break down the key policy terms leading to changes in uncertainty over time. By doing so, we have determined that tax, government spending, and health care policy uncertainty are the key factors driving the increases observed in figure 1 since 2008.

Intriguingly, monetary policy uncertainty does not appear to have risen particularly dramatically since 2008. Potentially this is because low and stable inflation and interest rates mean the mainstream US new media does not perceive any increase in monetary policy uncertainty.

Canada’s index of economic policy uncertainty is plotted in figure 2 and shows a similar time profile to the US. My view is that much of Canada’s current economic policy uncertainty is due to contagion from the US. Canada has had a relatively stable monetary and fiscal policy over the recent crisis and recovery, and economically has not suffered as much as the US. Nevertheless, uncertainty about US policies, which have a large economic impact on Canada due to the integrated nature of our two economies, leads to high levels of measured economic policy uncertainty for Canada.

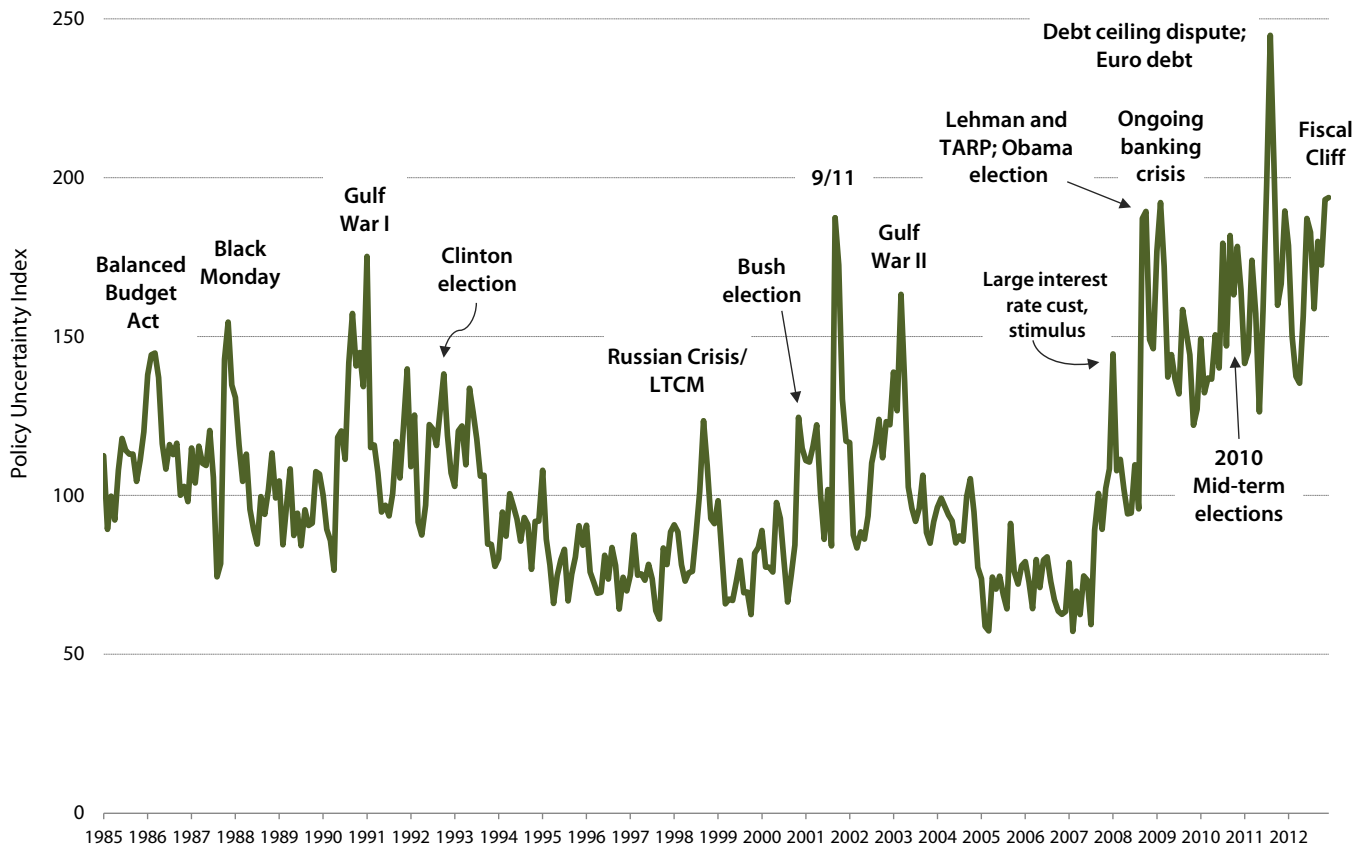
About the author



Nicholas Bloom is a Professor of Economics at Stanford University, and a Co-Director of the Productivity, Innovation and Entrepreneurship program at the National

Bureau of Economic Research (NBER). His research focuses on management practices and uncertainty. His work has been covered in the New York Times, Wall Street Journal, CNN, CNBC, BBC, the Economist, USA Today and the Financial Times. He has a BA from Cambridge, an MPhil from Oxford, and a PhD from University College London.

Figure 1: Index of US Economic Policy Uncertainty (Jan. 1985 – Dec. 2012)



Source: Baker, Bloom, and Davis, 2013. Index of Policy-related Economic Uncertainty is composed of 4 series: monthly news articles containing uncertain or uncertainty, economic or economy, and policy relevant terms (scaled by the smoothed number of articles containing “today”); the number of tax laws expiring in coming years, and a composite of IQ ranges for quarterly forecasts of federal, state, and local government expenditures and 1-year CPI from the Phil. Fed Survey of Forecasters. Weights: 1/2 news-based; 1/6 tax expirations; 1/6 CPI disagreement; 1/6 expenditures disagreement after each index normalized to have a standard-deviation of 1. Data from Jan 1985-Nov 2012. Index normalized mean 100 from 1985-2009. Data at www.policyuncertainty.com.

Is economic policy uncertainty damaging the recovery?

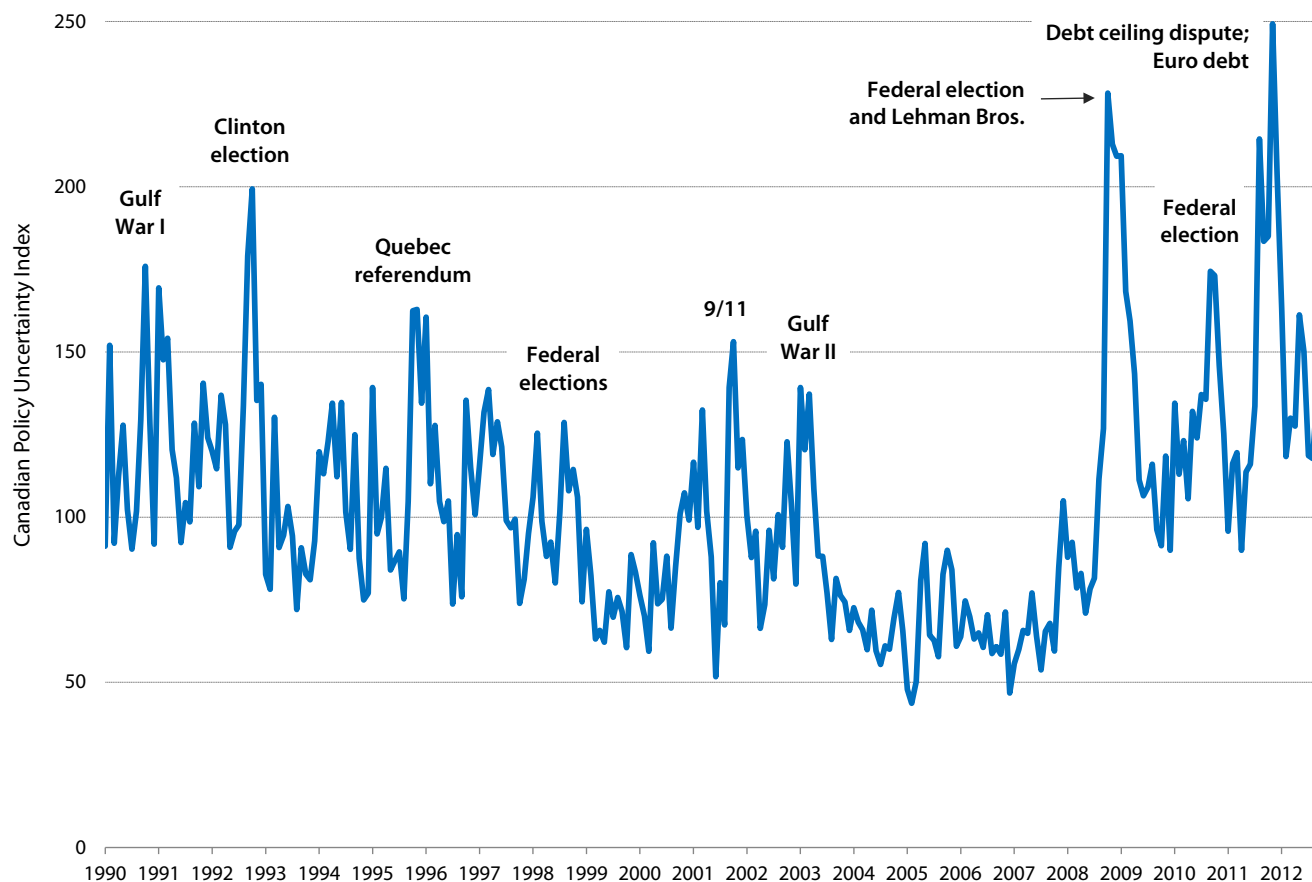
There are theoretically many reasons why uncertainty can damage growth. One of the earliest papers in the economics literature regarding uncertainty and economic growth is by Ben Bernanke (1983), the current Chairman of the Federal Reserve Board. Bernanke points out

that increases in uncertainty lead firms to defer investment, creating short, sharp recessions. But how big is this negative impact in practice?

To attempt to estimate the impact of policy uncertainty, Baker, Bloom, and Davis (2013) use a statistical analysis based on vector auto regressions (VAR) estimations for GDP growth and employment on our index for economic policy uncertainty, plus other key

economic factors like interest rates, inflation and stock-market levels. Increases in policy uncertainty forecast future drops in economic growth and employment. The magnitudes are also large. For example, the figures show that following an increase in policy uncertainty of the size seen on average between 2006 and 2011, industrial production drops by 2.5 percent and employment by 2.4 million in the US. These results are also robust to

Figure 2: Index of Canadian Economic Policy Uncertainty (Jan. 1990 – Oct. 2012)



Source: Baker, Bloom, and Davis, 2013. Created from an index of 50% weight on media searches of leading Canadian newspapers for words concerning the economy, uncertainty, and policy, and 50% weight on a disagreement index based on Consensus economics panel of economic forecasters. Created with help from Dorinda So of the Institute for Competitiveness and Prosperity (www.competeprosper.ca).

changes in the VAR estimation (for example, adding or removing different variables, changing variable ordering or timing, or including controls for other measures like the Michigan consumer confidence index).

An obvious concern is causality. Since policy-making is forward looking and responds to the economic cycle, perhaps our VAR-based results simply reflect a tendency for policy to become more volatile and unpredictable when an

economic downturn looms on the horizon. So we can also examine qualitative evidence, such as surveys from businesses and consumers about the factors influencing their decisions, which also suggests a role for policy uncertainty. For example, the 2012 National Federation of Independent Business's small firm survey reports that 35 percent of small firms complain about "uncertainty of government actions" as a critical problem. This category shared third place with the "cost of fuel." The top concerns, however,

were the "cost of health insurance" (52 percent), and more general "uncertainty over economic conditions" (38 percent) (Dunkelberg and Wade, 2012).

Will policy uncertainty remain high in the future?

The prospects for policy uncertainty falling in the near term do not appear bright. There are two reasons for pessimism. One is linked to

the current political agenda; the other to the polarization of the US political system.

Policy agenda

The deal reached at the end of 2012 to avert the so-called “fiscal cliff” did little to address the long-run US structural deficit. The deficit is both large and increasing due to rising health care costs, primarily from Medicare. To address this, either Medicare costs have to be contained, or taxes have to be raised substantially. The Democrats have fiercely resisted extensive controls on Medicare expenses, while the Republicans have fiercely resisted extensive increases in taxes. As such, the current scenario of lurching from policy crisis to policy crisis as each new debt-ceiling deadline arises appears likely to continue. This is not a uniquely American problem. Many other OECD countries have budgetary challenges too, but because US expenditure on health care as a share of GDP (roughly 19 percent) is approximately double the OECD average, these health care cost challenges are particularly acute in the US.

Polarization

Another factor that is hampering the ability to reach a compromise in Washington is the increasing polarization of the political system. In the House of Representatives, redistricting has led to an increasing share of congressional districts that are either strongly Democrat or strongly Republican. This means that the biggest threat to incumbents is not

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Editing, design, and production

Kristin McCahon

challenges from the opposition party, but from other party members in the primaries. As a result, politicians have little incentive to move to the middle of the political spectrum to defend against the opposition party, but instead want to move to the middle of the political spectrum as it is defined by their

Increases in uncertainty lead firms to defer investment, creating short, sharp recessions.

own party activists. This is leading to an increasingly large gap between the policies and voting behavior of the two parties. For example, Carroll et al. (2008) report that while the 90th Congress of 1967/68 showed considerable overlap in the voting patterns of Democrats and Republicans, the 110th Congress of 2007/2008 showed almost no overlap. Hence, getting agreement on policies in the House and even the Senate is becoming harder and harder over time as politicians polarize into two camps.

Where next?

Economic policy uncertainty has surged since the beginning of the 2007-2009 recession and has not fallen since. This is true in the US, but also in Canada and Europe. This uncertainty appears to be stalling the recovery from what has been the deepest recession since World War II.

Nobel Prize winning economist Milton Friedman had a “guitar string theory” of recessions. When you pluck a guitar string it bounces back, much like the economy. And the harder you pluck the string, the faster the rebound. But the stalled recovery following the 2007-2009 recession makes it appear as though the guitar string has snapped. The weight of historically high levels of policy uncertainty is stalling the recovery.

The outlook ahead is bleak. US businesses and consumers are going to have to live with many more years of heightened policy uncertainty. Given the integrated and interdependent nature of the US and Canadian economies, this US-based economic policy uncertainty will continue to impede and adversely affect Canadian economic growth. Put simply, the US and Canadian economies would benefit demonstrably if economic uncertainty emanating from policy were reduced. Unfortunately, this looks unlikely to occur soon. Economic policy uncertainty is the new normal.

Note

- 1 The “*” denotes any ending; for example, “uncertain,” “uncertainty,” or “uncertainties.”

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