



Statement before the House Committee on Small Business
Subcommittee on Economic Growth, Tax and Capital Access
On the State of the Small Business Economy

Policy Uncertainty and the Small-Business Economy

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February 16, 2017

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The Small Business Economy

The U.S. economy is still on the long way back to recovery from the 2007-2008 financial crisis. While conventional measures such as real GDP per capita have surpassed their pre-crisis peak, a number of weaknesses remains. Some of these are plausibly the result of the long and deep recession the country went through, while others are symptoms of more long-run trends. As an example of the former, the number of long-term unemployed workers is still significantly above its pre-crisis level. Weaknesses of the latter variety are arguably more worrisome, as there is no reason to believe that they will, with enough time, disappear.

Two examples of the latter are trends in levels of concentration within industries, and in entry of new firms. The former – illustrated by Figure 1 - suggests that small businesses have been losing ground in the US economy for quite some time now.

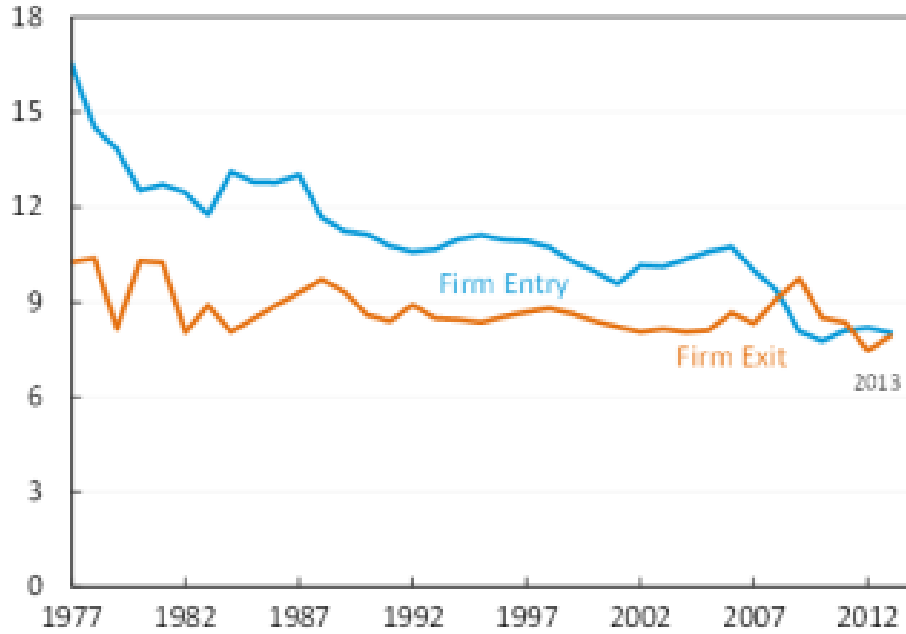
Industry	Revenue Earned by 50 Largest Firms, 2012 (Billions \$)	Revenue Share Earned by 50 Largest Firms, 2012	Percentage Point Change in Revenue Share Earned by 50 Largest Firms, 1997-2012
Transportation and Warehousing	307.9	42.1	11.4
Retail Trade	1,555.8	36.9	11.2
Finance and Insurance	1,762.7	48.5	9.9
Wholesale Trade	2,183.1	27.6	7.3
Real Estate Rental and Leasing	121.6	24.9	5.4
Utilities	367.7	69.1	4.6
Educational Services	12.1	22.7	3.1
Professional, Scientific and Technical Services	278.2	18.8	2.6
Administrative/ Support	159.2	23.7	1.6
Accommodation and Food Services	149.8	21.2	0.1
Other Services, Non-Public Admin	46.7	10.9	-1.9
Arts, Entertainment and Recreation	39.5	19.6	-2.2
Health Care and Assistance	350.2	17.2	-1.6

Note: Concentration ratio data is displayed for all North American Industry Classification System (NAICS) sectors for which data is available from 1997 to 2012.

Source: Economic Census (1997 and 2012), Census Bureau.

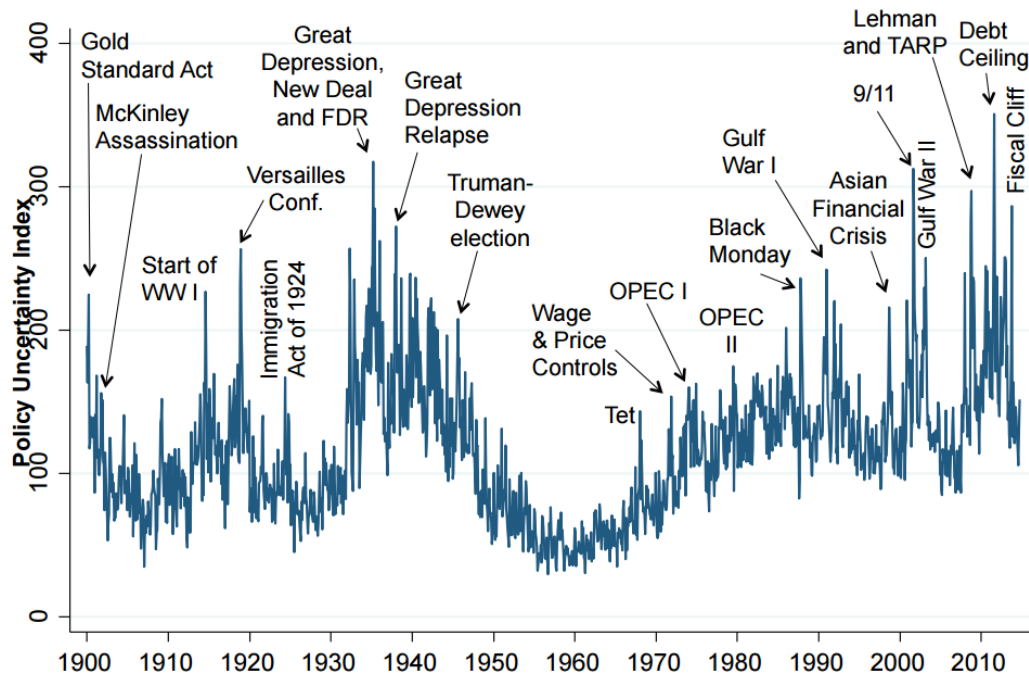
Figure 1 Change in Market Concentration by Sector, 1997-2012. Source: Council of Economic Advisors (2016).

The latter – illustrated by Figure 2 – shows that perhaps as a consequence, or maybe as a cause, entry by new firms has been on the decline for quite some time as well. During this same period, as Figure 3 shows, something else happened: uncertainty surrounding economic policy was elevated compared to the preceding decades.



Source: U.S. Census Bureau, Business Dynamics Statistics.

Figure 2 Firm Entry and Exit Rates, 1977-2013. Source: Council of Economic Advisors (2016).



Notes: Index reflects scaled monthly counts of articles in 6 major newspapers (Washington Post, Boston Globe, LA Times, NY Times, Wall Street Journal, and Chicago Tribune) that contain the same triple as in Figure 1, except the economy term set includes "business", "commerce" and "industry" and the policy term set includes "tariffs" and "war". Data normalized to 100 from 1900-2011.

Figure 3 Uncertainty in the Long Run. Source: <http://www.policyuncertainty.com>.

Policy Uncertainty and Economic Performance¹

A popular explanation for the significant duration of the 2007-2009 recession's recovery was the increase in economic-policy uncertainty during the period. Widely discussed in the popular news amidst analyses of the impact of Federal Reserve policy, health care reform, the rise of the Tea Party movement (see Madestam et al., 2013), debt ceiling disputes and state and federal spending levels, such uncertainty also received attention from researchers looking into its possible effects on the U.S. economy during the aftermath of the financial crisis.

Baker et al. (2016), for example, show that higher policy uncertainty from 2008 on was associated with a deeper and longer recession. In their analysis of news and government documents, Dominguez and Shapiro (2013) find that the political "stalemate" in the US contributed to the length of the recession, as did shocks from Europe. Similarly, Bachmann and Sims (2012) establish that consumer and firm confidence is of the utmost importance during downturns. Schaal (2011) is able to reproduce many of the dynamics of the Great Recession by introducing uncertainty shocks into a dynamic search model of heterogeneous firms, while Stock and Watson (2012) use a dynamic factor model to establish that heightened uncertainty worsened the recession significantly.

Moving away from the specific experience of the Great Recession for now, theoretical research has shown that policy uncertainty can affect consumption, investment (Rodrik, 1991) as well as broader economic activity (Bloom, 2009; Fernandez-Villaverde et al., 2015; Baker et al., 2016). While the foundations for believing that policy uncertainty can have negative effects on the broader economy have existed in the economics literature for some time (Friedman, 1968; Bernanke, 1983), recent research has introduced new ways to measure indicators of uncertainty, opening the door for empirical work. For example, Bertola et al. (2005) find that increased income uncertainty makes consumers postpone durable good purchases, while Julio and Yook (2012) examine corporate investment around national elections and find evidence that firms reduce investment when election outcomes are less certain. Baker et al (2016) develop a method for measuring policy uncertainty based upon newspaper coverage, expiring tax provisions, and economic forecaster disagreement, which has been used to examine past trends in policy uncertainty in the U.S. For example, Gulen and Ion (2012) use this index to show that policy uncertainty is negatively related to investment, both at the firm and industry levels, and that this uncertainty has had a substantial impact on corporate investment since the 2007 financial crisis. Meanwhile, Bachmann et al. (2013) use survey data to confirm that increases in uncertainty have a large and protracted impact on aggregate manufacturing production.

¹ This section draws heavily on Shoag and Veuger (2016) and earlier versions of that article.

All of these studies focus, in principle, on variation in uncertainty over time. In work with Daniel Shoag of Harvard (Shoag and Veuger, 2016), I seek to explain the cross-section of macroeconomic outcomes within the U.S. by studying policy uncertainty at the state level. We find that increases in local uncertainty over this period are strongly correlated with the effects of the recession, and that the correlation between uncertainty at the state level and employment losses is highly robust across alternate measures. While there is certainly a feedback loop between economic outcomes and uncertainty, we show that increases in local uncertainty are partially driven by preexisting state institutions, and that these pre-determined uncertainty amplifications cause unemployment increases.

Our baseline results suggest that if uncertainty levels in all states had been the same as those of the five states facing the lowest levels of uncertainty in 2009, they would have been associated with a national unemployment rate that was 0.8 and 1.2 percentage points lower. The key lesson from these findings is that, like structural change and demand driven channels, variation in policy uncertainty can partially explain the geographic pattern of the recession. Importantly, our results show that well-designed institutions and resilient public-sector operations can reduce policy uncertainty and produce better macroeconomic outcomes.

These various negative effects of heightened policy uncertainty are, if anything, of even more importance to small businesses. While economists often model firms as being risk-neutral, owned by a large number of shareholders with fully diversified portfolios, that is obviously not the case for the overwhelming majority of small businesses. As a consequence, small-business owners are likely to be more vulnerable to the risk induced by uncertain business environments. This makes it even more important for the committee to focus its attention on reducing policy uncertainty where that is possible.

Policy Uncertainty and the New Congress' Agenda

A number of the initiatives of the new Congress will be helpful in attaining this goal of creating more certainty about the business environment. The Small Business Regulatory Flexibility Improvements Act, for example, passed as a part of H.R. 5, the Regulatory Accountability Act, requires more careful consideration before new rules and regulations, demands that their impact on small business be considered more specifically, and mandates periodic of rules that significantly impact substantial numbers of small businesses. The HALOS Act, which also passed the House last month, is helpful on the other side of the ledger: by making it easier for startup firms to connect with angel investors and gain access to capital, the negative impact from heightened policy uncertainty will be somewhat dampened.

Despite measures like this, some measures of uncertainty have spiked since in the last few months. Figure 4, for example, shows that the Baker-Bloom-Davis monthly economic policy uncertainty index peaked in November to reach its highest level since August 2011, when the Eurozone crisis and arguments over raising the debt ceiling posed threats to economic stability, and has continued at an elevated level since.

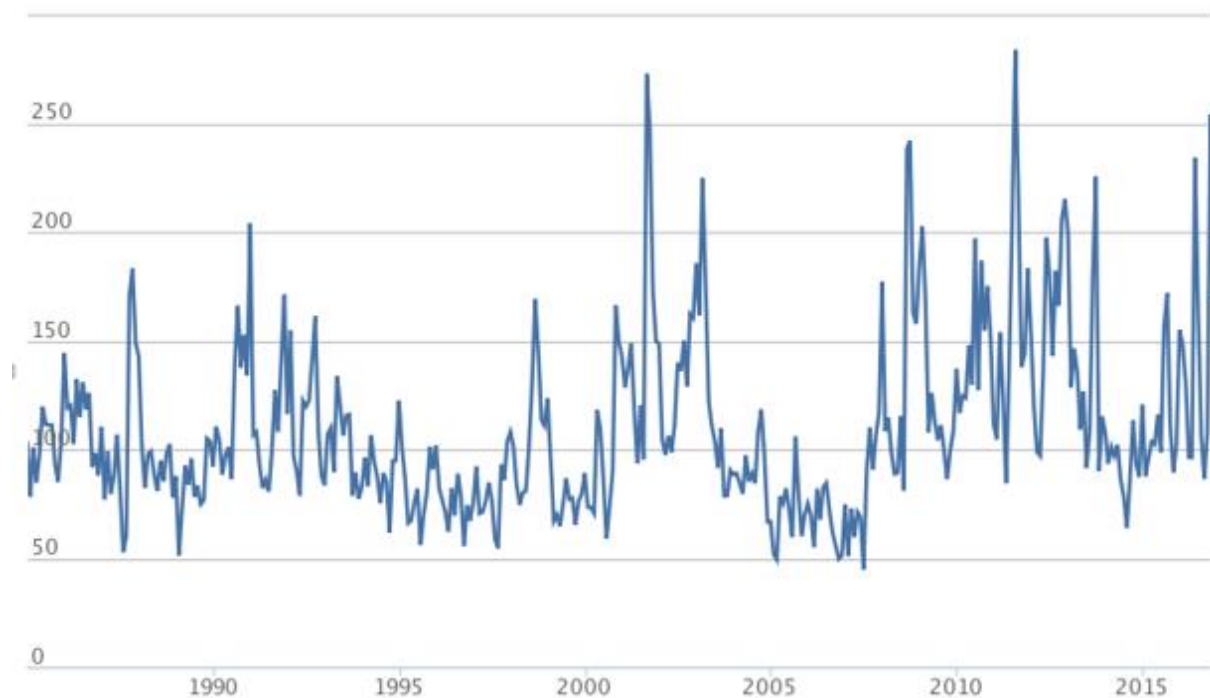


Figure 4 Economic Policy Uncertainty Index. Source: <http://www.policyuncertainty.com>.

Now, some of this can be attributed to the fact that we just recently had an election, and other potential uncertainty indicators – the VIX, for example - paint a different picture. That said, it does point to concerns about upcoming legislative and executive activity. For example, while repeal of the Affordable Care Act has long been a priority for Republicans, individuals and small businesses may worry about what would come next. Changes in immigration policy may induce uncertainty about the ability of startups to hire skilled employees. The recent executive order that imposed a travel ban on citizens of a number of Muslim-majority countries, including at least initially green-card holders, has left the over 10 million legal permanent residents in the country – owners, managers, employees, and customers of small businesses - wondering about their true status. Corporate tax reform, while long overdue and with the potential to add to potential growth and to improve the investment climate, will inevitably create winners as well as losers.

On the whole, James Madison's words in Federalist 62 still ring true today: "Great injury results from an unstable government. The want of confidence in the public councils damps

every useful undertaking, the success and profit of which may depend on a continuance of existing arrangements. What prudent merchant will hazard his fortunes in any new branch of commerce when he knows not but that his plans may be rendered unlawful before they can be executed? What farmer or manufacturer will lay himself out for the encouragement given to any particular cultivation or establishment, when he can have no assurance that his preparatory labors and advances will not render him a victim to an inconstant government?"

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